(10)

No. 92-1941-CFX
Status: GRANTED

Title: United States, Petitioner
v.
Jerry W. Carlton

Docketed:
June 7, 1993

Court: United States Court of Appeals for the Ninth Circuit

Counsel for petitioner: Solicitor General

Counsel for respondent: Allen,Russell G.

Entry	Date	Note	Proceedings and Orders
1	Jun 7 1993	G	Petition for writ of certiorari filed.
2	Jul 14 1993		DISTRIBUTED. September 27, 1993
4	Jul 14 1993		Brief of respondent Jerry W. Carlton in opposition filed.
3	Jul 15 1993	P	Response requested -- JPS. (Due August 16, 1993)
5	Jul 23 1993	X	Reply brief of petitioner filed.
6	Oct 4 1993		Petition GRANTED. The brief of petitioner is to be filed with the Clerk and served upon opposing counsel on or before 3 p.m., Tuesday, November 16, 1993. The brief of respondent is to be filed with the Clerk and served upon opposing counsel on or before 3 p.m., Tuesday, December 14, 1993. A reply brief, if any, is to be filed with the Clerk and served upon opposing counsel on or before 3 p.m., Wednesday, January 5, 1994. Rule 29 does not apply. **
7	Oct 6 1993	G	Motion of the Solicitor General to dispense with printing the joint appendix filed.
9	Nov 5 1993		Record filed.
		*	Partial proceedings United States Court of Appeals for the Ninth Circuit.
8	Nov 8 1993		Motion of the Solicitor General to dispense with printing the joint appendix GRANTED.
10	Nov 10 1993		Record filed.
		*	Original proceedings United States District Court for the Central District of California.
11	Nov 15 1993		Brief of petitioner United States filed.
12	Dec 10 1993	G	Motion of Anthony C. Morici for leave to file a brief as amicus curiae filed.
13	Dec 13 1993	G	Motion of The American Cause for leave to file a brief as amicus curiae filed.
14	Dec 14 1993		Brief of respondent Jerry W. Carlton filed.
15	Dec 14 1993	G	Motion of Washington Legal Foundation, et al. for leave to file a brief as amici curiae filed.
16	Dec 29 1993		SET FOR ARGUMENT MONDAY, FEBRUARY 28, 1994. (4TH CASE).
17	Jan 4 1994		CIRCULATED.
18	Jan 5 1994	X	Reply brief of petitioner United States filed.
19	Jan 10 1994		Motion of Anthony C. Morici for leave to file a brief as amicus curiae GRANTED.
20	Jan 10 1994		Motion of The American Cause for leave to file a brief as amicus curiae GRANTED.
21	Jan 10 1994		Motion of Washington Legal Foundation, et al. for leave to file a brief as amici curiae GRANTED.

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No. 92-1941-CFX

Entry	Date	Note	Proceedings and Orders
22	Feb 28 1994		ARGUED.

92-1941

No.

In the Supreme Court of the United States

OCTOBER TERM, 1992

UNITED STATES OF AMERICA, PETITIONER

v.

JERRY W. CARLTON

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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QUESTION PRESENTED

Whether curative legislation proposed in January 1987 and enacted in December 1987 retroactively to avert the potential abuse of an estate tax provision enacted in October 1986 violates due process when applied to a transaction entered into by an estate in December 1986.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-36a) is reported at 972 F.2d 1051. The opinion of the district court (App., *infra*, 38a-42a) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on August 10, 1992. A petition for rehearing with suggestion for rehearing *en banc* was denied on March 9, 1993 (App., *infra*, 37a). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES INVOLVED

The relevant portions of Section 2057 of the Internal Revenue Code of 1986, as originally enacted, and as amended by Section 10411 of the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330-432 to 1330-433, are set forth in the Appendix, *infra*, 43a-46a.

STATEMENT

1. This case concerns the estate tax liability of the estate of Willametta K. Day, who died on September 29, 1985. The estate tax return for her estate was initially due on June 29, 1986.[1] Respondent (the executor of Ms. Day's will) sought and obtained a six-month extension for the filing of the return.[2] The return was therefore due on December 29, 1986 (App., *infra*, 4a).

During the period of this six-month filing extension, Congress enacted the major revisions to the Internal Revenue Code contained in the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085. Section 1172 of that Act added a new estate tax provision applicable for estates that filed timely returns after the date of the Act, October 22, 1986. See 100 Stat. 2513-2515. The new estate tax provision was codified as Section 2057 of the Internal Revenue Code

[1] Under Section 6075(a) of the Internal Revenue Code, the estate tax return is to be filed within nine months of the decedent's death. 26 U.S.C. 6075(a).

[2] The Secretary may allow extensions of time for the filing of any return. But "no such extension shall be for more than 6 months." 26 U.S.C. 6081(a).

of 1986, 26 U.S.C. 2057 (Supp. IV 1986).[3] It established a deduction for estate tax purposes of one-half of the proceeds of "any sale of employer securities by the executor of an estate" to "an employee stock ownership plan" (26 U.S.C. 2057(a), (b) (Supp. IV 1986)). To qualify for the new estate tax deduction under Section 2057, the sale of securities had to be made by the executor "before the date on which the [estate tax] return * * * is required to be filed (including any extensions)." 26 U.S.C. 2057(c)(1) (Supp. IV 1986).[4]

2. Respondent sought to take advantage of this new provision in the following manner: (i) on December 10, 1986, respondent used estate funds to purchase 1,500,000 shares of the common stock of MCI Communications Corporation (MCI)[5] for $11,206,000 (representing an average price of $7.47 per share); (ii) on December 12, 1986, respondent sold the 1,500,000 shares of MCI stock to the MCI Employee Stock Ownership Plan for $10,575,000 (representing an average price of $7.05 per share); and (iii) based on these transactions, respondent claimed a deduc-

[3] In 1989, Section 2057 was repealed for the estates of all persons dying after December 19, 1989. See Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7304(a), 103 Stat. 2352-2353.

[4] "Employer securities" is defined in Section 2057 by reference to Section 409(*l*) of the Code, 26 U.S.C. 409(*l*) (Supp. IV 1986). In general, the term means common stock issued by the employer that is readily tradeable on an established securities market. See 26 U.S.C. 2057(e) (Supp. IV 1986).

[5] In December 1986, MCI was a publicly-traded stock listed on the NASDAQ exchange. Its daily trading volume during this period was several million shares. See, *e.g.*, Wall St. J., Dec. 5, 1986, at 56; *id.*, Dec. 3, 1986, at 54; *id.*, Dec. 2, 1986, at 64.

tion under Section 2057 of one-half of the proceeds of the sale of stock to the MCI plan (or $5,287,500) on the estate return which he filed on December 29, 1986. The result of the claimed deduction was to reduce the reported estate tax obligation by $2,501,161 (App., *infra*, 4a-5a, 7a).[6]

3. On January 5, 1987, the Internal Revenue Service announced that it was seeking curative legislation to clarify that the deduction under Section 2057 is available only to estates of decedents who owned the securities in question *prior* to death. Notice

[6] By purchasing the 1,500,000 shares of MCI stock at a market price of approximately $7.47 per share on December 10, 1986, and selling the stock at $7.05 per share to the MCI plan on December 12, 1986, the estate lost $631,000 on the transaction (App., *infra*, 4a-5a). But this loss was neither inevitable nor relevant to the claimed deduction.

The market price for MCI stock prevailing a few days earlier—on December 1 and December 2, 1986—was $6.50 per share. See Wall St. J., Dec. 2, 1986, at 64; *id.*, Dec. 3, 1986, at 54. If respondent had made his purchases on those dates at the market price of $6.50 per share, and had made the same sale of stock to the MCI plan on December 12, 1986, at the price of $7.05 per share which he in fact realized, the estate would have made a profit of $825,000 on the transaction. Even in that situation, however, the estate would still have claimed the same estate tax deduction of $5,287,500 under Section 2057, because the Section 2057 deduction is simply computed as one-half of the sale price. See 26 U.S.C. 2057(a) (Supp. IV 1986). Whether the estate made a profit or a loss on the sale is irrelevant to the deduction under Section 2057.

This case does not present the question of the proper tax treatment of the "loss" of $631,000 resulting from the purchase and sale of the MCI stock. Only the estate tax deduction (for one-half of the sale proceeds) under Section 2057 is at issue.

87-13, 1987-1 C.B. 432, 442. A bill to enact this proposed amendment to Section 2057 was introduced in both chambers of Congress on February 26, 1987. 133 Cong. Rec. 4145 (1987); 133 Cong. Rec. 4293 (1987).

When Section 2057 was originally enacted in 1986, Congress anticipated that the resulting benefit to taxpayers from the provision would be approximately $300,000,000. See 133 Cong. Rec. 4145 (1987). As Representative Rostenkowski, the Chairman of the House Ways and Means Committee, has noted, however, it became clear soon after passage of the 1986 Act that the projected revenue loss under Section 2057 could be as much as $7,000,000,000—more than twenty times the amount originally anticipated—because the statute did not explicitly limit the deduction to instances where the decedent owned the employer securities at the time of death. *Ibid.* Senator Bentsen, the Chairman of the Senate Finance Committee, observed that "Congress did not intend for estates to be able to claim the deduction by virtue of purchasing stock in the market and simply reselling the stock to an ESOP" (133 Cong. Rec. 4294 (1987)). The provision had not been intended to permit a deduction for "essentially sham transactions" (*ibid.*).

The Committee Report on enactment of the 1987 amendment states that, "[w]hile Congress intended to encourage transfers of employer securities to ESOPs by providing for partial elimination of estate tax liability, it was not intended that estates be able to eliminate all estate tax liability through use of the deduction" (H.R. Rep. No. 391, 100th Cong., 1st Sess., Pt. II, at 1045 (1987)). The Report concludes that "[t]he provision would not have been adopted in its present form had the full extent of the revenue

impact and effect of the provision been recognized" (*ibid.*). The Report explains that "[t]he modifications contained in the bill are designed to" "bring the revenue loss in line with the original estimate and Congressional intent" (*ibid.*).

The curative amendment to Section 2057 was enacted on December 22, 1987. The amendment was made effective as if it had been contained in the statute as originally enacted in October 1986. See Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10411, 101 Stat. 1330-432 to 1330-433. The statute as amended in 1987 provides that, to qualify for the estate tax deduction under Section 2057, the securities sold to the employee stock ownership plan must have been "directly owned" by the decedent "immediately before death" (Pub. L. No. 100-203, § 10411(a), 101 Stat. 1330-432; see also 26 U.S.C. 2057 note (Supp. V 1987)).[7]

4. The Internal Revenue Service disallowed the claimed deduction for the sale of MCI stock on Ms. Day's estate tax return because the stock had been purchased after Ms. Day's death and was not owned by her "immediately before death." Respondent paid the resulting estate tax deficiency of $2,501,161 and commenced this suit for refund in federal district court (App., *infra*, 5a, 7a).

Respondent acknowledged that the estate did not qualify for the deduction under the amended provisions of Section 2057. Respondent contended, however, that the estate qualified for the deduction under the original provisions of Section 2057 and that the

[7] A complementary, prospectively applicable provision was enacted at the same time. See 26 U.S.C. 2057 (Supp. V 1987); Pub. L. No. 100-203, §§ 10411(b), 10412, 101 Stat. 1330-433 to 1330-436.

1987 amendment to that statute could not constitutionally be applied retroactively. Respondent asserted that retroactive application of the 1987 amendment to the estate's 1986 transactions in MCI stock violated the Due Process Clause of the Fifth Amendment to the Constitution (App., *infra*, 7a-8a).

The district court rejected respondent's due process claim (App., *infra*, 39a-41a). The court emphasized that "the Supreme Court has expressed doubt that foreseeability of retroactive legislation is even a 'relevant consideration' in Due Process Clause analysis" (App., *infra*, 40a (quoting *Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. 717, 731-732 (1984))). Even assuming the relevance of foreseeability of the change, the court noted that "changes in tax laws are 'by [their] very nature * * * reasonably foreseeable'" and "the taxpayer assumes the risk that the tax burden on a particular transaction may increase pursuant to Congress's continual responsibility to carry out the necessary policies of taxation" (App., *infra*, 40a (quoting *Estate of Ekins* v. *Commissioner*, 797 F.2d 481, 483, 484 (7th Cir. (1986))). The court concluded that, while a statute that retroactively imposes a wholly new tax may be challenged under the Due Process Clause, a retroactive "amendment[] that bring[s] about certain changes in operation of the tax laws, rather than the creation of a wholly new tax" is not constitutionally defective (App., *infra*, 41a (quoting *United States* v. *Hemme*, 476 U.S. 558, 568 (1986))). The court held that the effect of the 1987 amendment on the availability of the Section 2057 deduction was not "harsh and oppressive" and that "retroactive application of the amendments to § 2057 [therefore] does not violate due process" (App., *infra*, 39a, 40a).

5. A divided panel of the court of appeals reversed (App., *infra*, 1a-36a). The court acknowledged at the outset that "retroactivity alone will not condemn a congressional enactment" (*id.* at 10a). The court rejected, however, "the notion of a per se rule that tax statutes can *always* be retroactively applied so long as they do not enact a 'wholly new' tax" (*ibid.*). The court concluded that the relevant inquiry under the Due Process Clause is whether "retroactive application is so harsh and oppressive as to transgress the constitutional limitation" (*id.* at 9a (quoting *United States* v. *Hemme*, 476 U.S. at 568-569)). In determining whether retroactive application of the 1987 amendment was "harsh and oppressive," the court looked to (i) whether "the taxpayer ha[d] actual or constructive notice that the tax statute would be retroactively amended" (App., *infra*, 17a), (ii) whether "the taxpayer rel[ied] to his detriment on the pre-amendment tax statute" (*ibid.*), and (iii) whether such reliance was "reasonable" (*ibid.*).

The court concluded that retroactive application of the 1987 amendment violated due process because each of these three criteria was met in this case. Respondent lacked actual or constructive notice that the statute would be amended retroactively because "no act of the executive or legislative branch would have given any forewarning of the 1987 amendment at the time the MCI ESOP transaction occurred" (App., *infra*, 17a-18a). The court reasoned that respondent had "detrimentally relied on section 2057 as [originally] enacted" (*id.* at 19a) because he had "engaged in a costly transaction for no other reason than the inducement provided by the new section 2057" (*ibid.*). Although denial of the Section 2057

deduction would not detrimentally affect the estate's tax liability—for the taxes owed would be no greater than "if the ESOP proceeds deduction had never been enacted in the first place" (*id.* at 22a)—the court asserted that this "fails to account for the actual loss suffered by the estate" (*ibid.*):

> It was too late for [respondent] to undo his sale to the MCI ESOP. The $631,000 [loss on respondent's purchase and sale of MCI stock] was gone forever, irretrievable. [App., *infra*, 19a.]

The court reasoned that this $631,000 loss represented the type of "detrimental reliance" that made retroactive application of the 1987 amendment unconstitutional (*ibid.*).

Finally, the court concluded that "the estate's reliance on the plain language of section 2057 was reasonable in light of the lack of any indication that an amendment was in the offing and in the context of the large tax incentives Congress has given to ESOPs" (App., *infra*, 23a). Due to the reasonable, detrimental reliance of the estate and the unforeseeability of the amendment, the court concluded that retroactive application of the 1987 amendment to Section 2057, "as applied here, * * * is 'so harsh and oppressive as to transgress the constitutional limitation'" (App., *infra*, 24a).

Judge Norris dissented (App., *infra*, 25a-36a). He pointed out that deductions are purely a matter of legislative grace and that Congress has full power to revoke such benefits retroactively (App., *infra*, 30a (citing *Miller* v. *Commissioner*, 115 F.2d 479, 480 (9th Cir. 1940), cert. denied, 312 U.S. 703 (1941)). He further noted that "[t]he Supreme Court and our sister circuits have made clear * * * that constructive notice to the taxpayer is usually implied

for a change in the rate or basis of an existing tax" (App., *infra*, 29a). He concluded that "[t]he majority, in reaching a different conclusion, creates a split among the circuits, as well as a conflict with our own, older precedent" (*id.* at 30a):

> I recognize that, if this case raised a question of statutory interpretation, neither the provision's legislative history nor its unfortunate economic effects could detract from the plain meaning of the text [of the original statute]. * * * But this case does not require us to interpret the 1986 statute, only to inquire whether Congress, in amending it, acted in an arbitrary and capricious manner, or "so harsh[ly] and oppressive[ly] as to transgress the constitutional limitation." *Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*, [467 U.S. 717, 733 (1984)]. Because Congress's retroactive legislation limited the scope of a loophole that had been in effect just over one year, it did not transgress that boundary. [App., *infra*, 35a-36a.]

REASONS FOR GRANTING THE PETITION

The decision of the court of appeals adopts and applies a novel and erroneous three-step substantive due process test for determining the constitutionality of retroactive tax legislation. The court's new test conflicts with the standards articulated under the Due Process Clause by this Court and by the other courts of appeals.

While the particular issue involved in this case concerns the administration of estates only during the period from October 1986 to January 1987,[8] the

[8] The amendments to Section 2057 were proposed to Congress in January 1987 and were enacted in December 1987. The court of appeals stated that "[w]e do not doubt the power of Congress to apply legislation retroactively to the time such legislation was introduced, or even to the time such legislation was proposed by the executive branch. * * * During this time period, the taxpayer is on notice that a change in law is forthcoming." App., *infra*, 24a.

decision of the court of appeals has substantial continuing importance. As this Court has noted, Congress is frequently called upon to make "retroactive revisions of the federal * * * revenue laws" and, in doing so, often "impose[s] taxes on subjects previously untaxed and shift[s] the burden of old taxes by changes in rates, exemptions and deductions" (*Welch* v. *Henry*, 305 U.S. 134, 145 (1938)). By announcing a new and unsupported method of due process analysis for retroactive tax legislation, the decision of the court of appeals provides a substantial windfall to respondent's estate and threatens seriously to impede routine enforcement of the federal revenue laws in a circuit that includes a substantial portion of the Nation's taxpayers and economic activity.

1. a. The era in which the Due Process Clause may be invoked as a substantive limitation on government regulation of commercial affairs has ended. The "guaranty of due process" in the regulation of commercial matters "demands only that the law shall not be unreasonable, arbitrary and capricious, and that the means selected shall have a real and substantial relation to the object sought to be attained." *Nebbia* v. *New York*, 291 U.S. 502, 525 (1934). As this Court stated in *Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 729:

> [T]he strong deference accorded legislation in the field of national economic policy is no less applicable when that legislation is applied retroactively. Provided that the retroactive applica-

> tion of a statute is supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches.

The burden of sustaining retroactive legislation under the Due Process Clause is therefore "met simply by showing that the retroactive application of the legislation is itself justified by a rational legislative purpose." *Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 730. Accord, *United States* v. *Sperry Corp.*, 493 U.S. 52, 64-65 (1989). Whether a "wiser or more practical" approach might be thought desirable "is not a question of constitutional dimension." *Usery* v. *Turner Elkhorn Mining Co.*, 428 U.S. 1, 19 (1976).

In a series of cases that began during the period in which the Court still employed the doctrine of substantive due process to limit the scope of permissible legislative judgments, the Court has stated that "retrospective civil legislation may offend due process if it is 'particularly "harsh and oppressive"' " (*Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 733, quoting *United States Trust Co.* v. *New Jersey*, 431 U.S. 1, 17 n.13 (1977), quoting *Welch* v. *Henry*, 305 U.S. at 147).[9] The Court recently made

[9] Prior to *Nichols* v. *Coolidge*, 274 U.S. 531 (1927), "no federal revenue measure ha[d] ever been held invalid on the score of retroactivity." *Untermyer* v. *Anderson*, 276 U.S. 440, 449 (1928) (Brandeis, J., dissenting). In a series of cases in the late 1920's, however, the Court invalidated the retroactive application of certain taxes that the Court found to be "wholly unreasonable" (*Blodgett* v. *Holden*, 275 U.S. 142, 147 (1927) (opinion of McReynolds, J.)) and "whimsical and burdensome" (*Nichols* v. *Coolidge*, 274 U.S. at 542).

clear, however, that the "harsh and oppressive" standard of review for retroactive legislation under the Due Process Clause does not permit courts to reweigh the wisdom or fairness of the legislation (*Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 729). Instead, the requirement that retroactive legislation not be "harsh and oppressive" is "met simply by showing that the retroactive application of the legislation" is rationally designed to ac-

In dissenting from the Court's holding that various retroactive features of the first federal gift tax were "oppressive" and violated the Due Process Clause, Justice Holmes stated, in *Untermyer* v. *Anderson*, 276 U.S. at 446:

> I find it hard to state to myself articulately the ground for denying the power of Congress to lay the tax. We all know that we shall get a tax bill every year. * * * A tax may be levied for past privileges and protection as well as for those to come.

Justice Brandeis wrote a separate dissent in the *Untermyer* case, concluding that the Court had invalidated the retroactive features of the federal gift tax simply "because the action of the law-making body is, in its opinion, unreasonable." 276 U.S. at 447. Justice Brandeis stated that, "[f]or more than half a century, it has been settled that a law of Congress imposing a tax may be retroactive in its operation" and that in numerous instances an "additional tax [had been] imposed after the taxes for the year had been paid." *Id.* at 447, 448. Justice Brandeis noted, moreover, that the retroactive features of the federal gift tax challenged in *Untermyer* had "a special justification" because they were designed to prevent evasions of the tax. *Id.* at 450. As Justice Brandeis queried, in a comment also applicable to the present case, "Is Congress powerless to prevent such evasion by the vigilant and ingenious?" *Id.* at 450-451.

complish a legitimate legislative purpose (*id.* at 730, 733). See *id.* at 732; *Usery* v. *Turner Elkhorn Mining Co.*, 428 U.S. at 16. Retroactive legislation rationally drawn to achieve a legitimate purpose does not violate the Due Process Clause even if the statute imposes a liability that "was not anticipated" or "upsets otherwise settled expectations" and "even though the effect of the legislation is to impose a new duty or liability based on past acts." *Ibid.*

b. Legislation designed to cure errors in the drafting of tax legislation, and to close loopholes unintentionally created in the legislative process, is an especially fit subject for retroactive, as well as prospective, treatment. It is a particular manifestation of the broad discretion vested in Congress to decide which groups of taxpayers are sufficiently similarly situated to warrant similar treatment. Congress unquestionably has a legitimate interest in designing revenue laws to fairly allocate to taxpayers the burdens and benefits of national fiscal policies and to prevent evasion of those laws "by the vigilant and ingenious" (see note 9, *supra*). If an unintended loophole is written into an enacted statute, and if Congress acts promptly to correct that error through curative legislation, it cannot be said that retroactive correction of the error lacks a rational relationship to the government's legitimate legislative objective. A curative, retroactive statute rationally designed to accomplish that legitimate purpose satisfies the requirements of due process. See *Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 729, 733. See also *Graham & Foster* v. *Goodcell*, 282 U.S. 409, 428 (1931) (Congress's "power to enact curative stat-

utes" is "unquestionably valid") (quoting *United States* v. *Heinszen & Co.*, 206 U.S. 370, 387 (1907)).

For this reason, prior to the decision in this case, "[c]ourts have consistently upheld the retroactive application of 'curative' legislation which corrects defects subsequently discovered in a statute and which restores what Congress had always believed the law to be" (*Long* v. *IRS*, 742 F.2d 1173, 1183 (9th Cir. 1984) (upholding retroactive amendment to the definition of "return information" under Section 6103 of the Code)).[10] If Congress were unable retroac-

[10] Courts routinely have upheld retroactive tax legislation. Among the statutes considered and upheld are: (i) legislation including amounts withheld from employees' wages pursuant to salary reduction plans in the social security wage base (*New England Baptist Hospital* v. *United States*, 807 F.2d 280, 285 (1st Cir. 1986); *Canisius College* v. *United States*, 799 F.2d 18, 27 (2d Cir. 1986), cert. denied, 481 U.S. 1014 (1987); *Temple University* v. *United States*, 769 F.2d 126, 135 (3d Cir. 1985), cert. denied, 476 U.S. 1182 (1986)); (ii) legislation clarifying that the annual gift tax exclusion applies only to gifts valued at less than $3,000, and that the amount of the annual exclusion is not deductible from the value of gifts over that amount (*Reed* v. *United States*, 743 F.2d 481, 485 (7th Cir. 1984), cert. denied, 471 U.S. 1135 (1985); *Estate of Ceppi* v. *Commissioner*, 698 F.2d 17, 21 (1st Cir.), cert. denied, 462 U.S. 1120 (1983)); (iii) a retroactive amendment clarifying that investment credit recapture is not to be taken into account in computing minimum tax liability when an unintended relief from liability for recapture would result (*Wiggins* v. *Commissioner*, 904 F.2d 311, 314 (5th Cir. 1990) ("We do not see how a new tax has been imposed by eliminating a loophole.")); (iv) the retroactive elimination of the applicability of the annual gift tax exclusion to transfers of interests in life insurance (*Estate of Ekins* v. *Commissioner*, 797 F.2d at 484-485; *Fein* v. *United States*, 730 F.2d 1211, 1213-1214 (8th Cir.), cert. denied, 469 U.S. 858 (1984)); and (v) an amendment to Section

tively to correct loopholes unintentionally enacted in revenue laws, it would be left "powerless to carry out the yearly tinkering with the Code that is necessary to prevent losses of revenue and secure the national fiscal goal" (*Estate of Ekins* v. *Commissioner*, 797 F.2d at 485).

c. Measured by this proper standard, the 1987 amendment to Section 2057 does not offend due process. Retroactive application of the amendment to the date the statute was originally enacted (in October 1986) represents a rational method of accomplishing a legitimate governmental purpose.

Soon after the original enactment of Section 2057, Congress discovered that the statute contained an unintended loophole that threatened a staggering revenue loss. Congress had never contemplated application of the Section 2057 deduction to post-death purchases and sales of securities by estate administrators. Application of the statute in that manner vastly expanded the scope and effect of the deduction. See page 4, *supra*. Absent any amendment, the statute would ostensibly permit estate tax deductions for transactions that had no purpose other than tax avoidance. But Congress "did not intend for estates to be able to claim the deduction by virtue of purchasing stock in the market and simply reselling the stock to an ESOP" (133 Cong. Rec. 4294 (1987) (Sen. Bentsen)). It would have been extraordinary for Congress to provide a deduction for such "essentially sham transactions" (*ibid.*). It was therefore necessary for Congress promptly and retroactively to correct the legislation that, on its face, permitted such patent abuse. As this Court has recognized, Congress may be "properly concerned" with the need for retroactivity to prevent abuse of its tax legislation. *Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 730.

6621 retroactively clarifying, in the wake of an adverse court decision, that the increased rate of interest applicable to tax-motivated transactions applies to sham transactions (*DeMartino* v. *Commissioner*, 862 F.2d 400, 408-409 (2d Cir. 1988)).

The means Congress employed to correct the potential abuse of Section 2057 was rationally related to this purpose. The 1987 amendment to the statute was made retroactive for "only that * * * period that Congress believed would be necessary to accomplish its purposes" (*Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 731). By making the curative legislation retroactive for the three-month period (October 1986 to January 1987) that preceded proposal of the 1987 amendment, the statute provides a uniform rule for all estates to which the deduction is available. It did not deny the benefits of the deduction to any estate that made a sale of securities that the decedent owned at death. The retroactive (and prospective, see note 7, *supra*) amendment merely forestalls abusive use of the statute by any estate to generate deductions for tax-motivated, "essentially sham transactions" of the type in which respondent engaged.

2. In concluding that respondent is constitutionally entitled to different tax treatment from that accorded taxpayers engaging in similar transactions after January 1987, the decision of the court of appeals is virtually the only modern case to strike down a retroactive amendment to an existing tax on due process grounds. As Judge Norris noted in dissent, "[t]he majority's opinion substitutes a test much

more sympathetic to the taxpayer than those that courts have used in the past" (App., *infra*, 31a).

The three-step due process test adopted by the court of appeals for retroactive tax legislation looks to (i) whether the taxpayer had "actual or constructive notice that the tax statute would be retroactively amended" (App., *infra*, 17a), (ii) whether the taxpayer relied "to his detriment on the pre-amendment tax statute" (*ibid.*), and (iii) whether such reliance was "reasonable" (*ibid.*). For the reasons we have already set forth, this three-part test (which would import common law concepts of promissory estoppel into the Due Process Clause) lacks any basis in the Constitution and conflicts with the decisions of this Court and the other courts of appeals.

a. It is well established that every taxpayer is deemed to have constructive notice of the possibility of changes in the provisions of existing tax laws. "Nobody has a vested right in the rate of taxation." *Cohan* v. *Commissioner*, 39 F.2d 540, 545 (2d Cir. 1930) (L. Hand, J.). The tax "system being already in operation," the taxpayer "must be prepared for such possibilities." *Ibid.* Every taxpayer "should be regarded as taking his chances of any increase in the tax burden which might result from carrying out the established policy of taxation." *Milliken* v. *United States*, 283 U.S. 15, 23 (1931) (rejecting due process challenge to retroactive application of change in tax rate for certain gifts made prior to amendment). Taxpayers cannot "justly assert surprise or complain of arbitrary action" when Congress retroactively adjusts prior tax legislation in light of experience "at the first opportunity after knowledge of the nature and amount of the income is available." *Welch* v. *Henry*, 305 U.S. at 150.[11] See also *United States* v. *Hemme*, 476 U.S. at 568; *United States* v. *Darusmont*, 449 U.S. 292, 298 (1981) (per curiam).

[11] In *Welch* v. *Henry*, 305 U.S. at 147, the Court distinguished the *Nichols*, *Blodgett* and *Untermyer* decisions (see note 9, *supra*), which had held retroactive features of the first federal gift tax unconstitutional. As the Court stated in *United States* v. *Hemme*, 476 U.S. at 568, those decisions involved retroactive application of an entirely new type of tax; their "authority is of limited value in assessing the constitutionality of subsequent amendments that bring about certain changes in operation of the tax laws, rather than the creation of a wholly new tax."

Notwithstanding this Court's admonition concerning the limited relevance of *Untermyer* and its progeny to cases involving "changes in operation of the tax laws," the court of appeals in the present case relied extensively on *Nichols*, *Blodgett* and *Untermyer* "to elucidate the factors we must consider in our determination" (App., *infra*, 11a). By contrast, the other courts of appeals have consistently followed this Court's lead and limited those decisions to cases involving a "wholly new tax." See, *e.g.*, *Estate of Ekins* v. *Commissioner*, 797 F.2d at 484; *Fein* v. *United States*, 730 F.2d at 1213-1214 ("the modern trend of decisions has uniformly been to limit" *Untermyer* to the "narrow situation" there involved); *Estate of Ceppi* v. *Commissioner*, 698 F.2d at 21 (in light of *Milliken*, "*Untermyer* at best remains good law only for the proposition that a wholly new gift tax cannot be applied retroactively"); *Westwick* v. *Commissioner*, 636 F.2d 291, 292 (10th Cir. 1980) (per curiam) (limiting *Untermyer* to "wholly new types of taxes"); *Buttke* v. *Commissioner*, 625 F.2d 202, 203 (8th Cir. 1980) (per curiam) (*Untermyer* bars "retroactive application of [a] wholly new tax"), cert. denied, 450 U.S. 982 (1981); *Shanahan* v. *United States*, 447 F.2d 1082, 1083 (10th Cir. 1971) ("*Untermyer* has been vitiated by Milliken v. United States."); *First National Bank* v. *United States*, 420 F.2d 725, 730 n.8 (Ct. Cl.) ("it is not entirely clear, in light of the above and the ever-increasing role of taxation in every area of activity, that the

Moreover, in the particular context of this case, it did not require a sophisticated executor to recognize that "the statute on its face offered a benefit that appeared 'too good to be true'" (App., *infra*, 34a) (Norris, J., dissenting). By enacting a curative amendment to ensure that the statute did not permit the unmerited and unprecedented windfall that respondent seeks, Congress did no more than confirm the rational expectation that the statute is not intended to reward purely tax-motivated, "essentially sham transactions" (133 Cong. Rec. 4294 (1987) (Sen. Bentsen)).

b. The court of appeals' concern over respondent's alleged "detrimental reliance" on the original version of Section 2057 lacks both a legal and a factual foundation. The court concluded that the estate had relied on the statute to its detriment by engaging in a purchase and sale of MCI stock that resulted in a loss to the estate of $631,000. See note 6, *supra*. But, whether the estate makes a profit or a loss on its purchase and sale of stock is irrelevant to the availability of the Section 2057 deduction: the deduction is calculated simply as one-half of the gross proceeds received from the sale. See 26 U.S.C. 2057(a) (Supp. IV 1986).

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same result would obtain in these early cases [referring to *Nichols* v. *Coolidge*, *Blodgett* v. *Holden*, and *Untermyer* v. *Anderson*] were they before the Court today"), cert. denied, 398 U.S. 950 (1970); *Sidney* v. *Commissioner*, 273 F.2d 928, 932 (2d Cir. 1960) (Friendly, J.) ("If Untermyer remains authority at all, it is so only for the particular situation of a wholly new type of tax."). See also Hochman, *The Supreme Court and the Constitutionality of Retroactive Legislation*, 73 Harv. L. Rev. 692 (1960); Ballard, *Retroactive Federal Taxation*, 48 Harv. L. Rev. 592 (1935).

Moreover, in this case (as in almost any case involving publicly-traded stock), respondent could have made a profit as easily as a loss on the estate's transaction. While the court of appeals emphasized repeatedly that the "estate was out $631,000" on its transaction in MCI stock (App., *infra*, 23a), if respondent had purchased the MCI stock only a few days earlier, the sale would have netted the estate a sizeable profit instead of a loss. See note 6, *supra*. In either situation, the amount of the claimed deduction under Section 2057 would be the same. See note 6, *supra*.[12]

The necessary implication of the court's rationale is that the constitutionality of the amending legislation turns on whether respondent timed his purchases of MCI stock well or poorly.[13] That unprecedented reasoning lacks any support in the Constitution.

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[12] Moreover, but for the fact that respondent was granted an extension to December 1986 of the time to file the estate tax return, the return would have been due in June 1986, before Section 2057 was enacted. See page 2, *supra*. When enacted, Section 2057 was made applicable only to estates for which returns had not then been filed. See page 2, *supra*. The estate cannot be said to have suffered any detriment from the denial of a deduction to which, but for the grant of a discretionary extension, it would not have been entitled in the first place.

[13] In concluding that Section 2057 "was enacted to induce taxpayers to sell shares at a discounted price to an ESOP" (App., *infra*, 19a), the court of appeals misconstrued the purpose of the statute. As Judge Norris noted in dissent (*id.* at 34a), Section 2057 was enacted as an "incentive for stockholders to sell their companies to their employees who helped them build the company rather than to liquidate, sell to outsiders or have the corporation redeem their shares on behalf of existing shareholders" (Staff of the Joint Commit-

c. The court further erred in concluding that respondent's purported reliance on Section 2057 was "reasonable" (App., *infra*, 23a). For the reasons we have described, respondent should reasonably have anticipated enactment of curative legislation to avoid use of Section 2057 to generate deductions for such abusive, tax-motivated transactions. See page 17, *supra*.

Moreover, contrary to the holding of the court of appeals in this case, a retroactive amendment to tax legislation is not unreasonable merely because it upsets "otherwise settled expectations." *Usery* v. *Turner Elkhorn Mining Co.*, 428 U.S. at 16. Retroactive tax legislation has often been enacted and often been upheld. See, *e.g.*, *United States* v. *Darusmont*, 449 U.S. at 298, quoting *Welch* v. *Henry*, 305 U.S. at 146-147. The power to enact such legislation is most compelling when a matter of legislative grace —such as a deduction, exemption or other privilege —is at stake. See *Miller* v. *Commissioner*, 115 F.2d 479, 480 (9th Cir. 1940), cert. denied, 312 U.S. 703 (1941). A taxpayer cannot "justly assert surprise" when, as here, Congress retroactively cures an error

tee on Taxation, 99th Cong., 1st Sess., *Tax Reform Proposals: Tax Treatment of Employee Stock Ownership Plans (ESOPs)* 37 (Comm. Print 1985)). See also 132 Cong. Rec. 14,507 (1986) (statement of Sen. Long). The statute sought to encourage stockholders who had built companies to sell their shares to ESOPs—not merely to encourage ESOPs to buy shares from the public at a discounted price. If the statute had only the purpose ascribed to it by the court of appeals majority, "Congress could more providently have underwritten ESOP stock purchases directly from the U.S. Treasury without bringing in estate executors as middlemen!" (App., *infra*, 35a) (Norris, J., dissenting).

in prior legislation "at the first opportunity" (*Welch* v. *Henry*, 305 U.S. at 150).

The emphasis of the court of appeals on the taxpayer's alleged "detrimental reliance" is particularly inappropriate in tax cases because "[t]axation is neither a penalty imposed on the taxpayer nor a liability which he assumes by contract" (*United States* v. *Darusmont*, 449 U.S. at 298, quoting *Welch* v. *Henry*, 305 U.S. at 146). A taxpayer cannot "reasonably" assume that an error in tax legislation will not be corrected. See *Graham & Foster* v. *Goodcell*, 282 U.S. at 428. This conclusion is especially appropriate when, as here, the statute on which the taxpayer assertedly relies "on its face offered a benefit that appeared 'too good to be true'" (App., *infra*, 34a) (Norris, J., dissenting)).

3. Congress is frequently required to make "retroactive revisions of the federal * * * revenue laws" (*Welch* v. *Henry*, 305 U.S. at 145). Such revisions are needed to correct prior drafting errors, to "impose[] taxes on subjects previously untaxed" and to "shift[] the burden of old taxes by changes in rates, exemptions and deductions" (*ibid.*). In preparing tax legislation, it is not always possible for Congress to foresee all possible applications of proposed statutory language. An opportunity to correct unintended applications of revenue laws at the earliest opportunity is necessary to ensure that taxing schemes (whether new or old) will not be evaded "by the vigilant and ingenious" (*Untermyer* v. *Anderson*, 276 U.S. at 450-451 (Brandeis, J., dissenting)). By depriving Congress of that reasonable opportunity, the decision of the court of appeals in this case threatens substantially to interfere with the ordinary enforcement of the revenue laws in a circuit that encom-

passes a significant portion of the Nation's taxpayers and economic activity.

Revisions in federal tax laws are enacted every year. It is a common practice for tax laws, and revisions to such laws, to be retroactive in varying degrees. There is often little if any advance warning of such legislation: changes in proposed tax legislation are often made (and entirely new provisions are often added) in Conference Committee without any public notice. By imposing evidently insurmountable obstacles to such reasonable legislative action, the decision in this case adopts a standard of review that conflicts with the decisions of this Court and the other courts of appeals. See note 10, *supra*. The court of appeals has, by its failure to adhere to this Court's precedents, held an Act of Congress unconstitutional. Further review by this Court is therefore warranted.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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APPENDIX A

UNITED STATES COURT OF APPEALS
NINTH CIRCUIT

No. 91-55590

JERRY W. CARLTON, Executor of the Will of WILLAMETTA K. DAY, PLAINTIFF-APPELLANT

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLEE

Appeal from the United States District Court for the Central District of California

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Argued and Submitted May 4, 1992

Decided Aug. 10, 1992

Before: ALARCON, NORRIS, and O'SCANNLAIN, Circuit Judges.

O'SCANNLAIN, Circuit Judge:

We consider whether retroactive application of an amendment to the federal estate tax portion of the Internal Revenue Code violates due process.

I

On October 22, 1986, the Tax Reform Act of 1986 ("TRA") became law. One provision of the TRA allowed an estate to deduct half of the proceeds of a sale of securities to an Employee Stock Ownership Plan ("ESOP") from a decedent's gross estate ("the ESOP proceeds deduction"). *See* 26 U.S.C. § 2057 [1]

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[1] Sec. 2057. SALES OF EMPLOYER SECURITIES TO EMPLOYEE STOCK OWNERSHIP PLANS OR WORKER-OWNED COOPERATIVES.

(a) *General Rule.*—For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate an amount equal to 50 percent of the qualified proceeds of a qualified sale of employer securities.

(b) *Qualified Sale.*—For purposes of this section, the term "qualified sale" means any sale of employer securities by the executor of an estate to—

(1) an employee stock ownership plan . . . described in section 4975(e)(7), or

(2) an eligible worker-owned cooperative (within the meaning of section 1042(c)).

(c) *Qualified Proceeds.*—For purposes of this section—

(1) *In general.*—The term "qualified proceeds" means the amount received by the estate from the sale of employer securities at any time before the date on which the return of the tax imposed by section 2001 is required to be filed (including any extensions).

(2) *Proceeds from certain securities not qualified.*—The term "qualified proceeds" shall not include the proceeds from the sale of any employer securities if such securities were received by the decedent—

(A) in a distribution from a plan exempt from tax under section 501(a) which meets the requirements of section 401(a), or

(repealed 1989). The result of the ESOP proceeds deduction was to remove half of the estate from the reach of the federal estate tax, to the extent the estate was comprised of money received from the sale of stock to an ESOP. This deduction, codified at section 2057 of the Internal Revenue Code, was available to any estate that could timely file its return after the enactment date of the TRA, irrespective of the date of death of the decedent. *See* 26 U.S.C. § 2057(c)(1).

The 99th Congress adjourned on October 18, 1986. Between passage by Congress of the TRA on September 27, 1986 and adjournment, Congress considered hundreds of potential technical and clerical

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(B) as a transfer pursuant to an option or other right to acquire stock to which section 83, 422, 422A, 423, or 424 applies.

(d) *Written Statement Required.*—

(1) *In general.*—No deduction shall be allowed under subsection (a) unless the executor of the estate of the decedent files with the Secretary the statement described in paragraph (2).

(2) *Statement.*—A statement is described in this paragraph if it is a verified written statement of—

(A) the employer whose employees are covered by the plan described in subsection (b)(1), or

(B) any authorized officer of the cooperative described in subsection (b)(2),

consenting to the application of section 4979A with respect to such employer or cooperative.

(e) *Employer Securities.*—For purposes of this section, the term "employer securities" has the meaning given such term by section 409(1).

(f) *Termination.*—This section shall not apply to any sale after December 31, 1991.

amendments to the TRA, but only one proposed amendment related to section 2057: deletion of an extraneous "is." Furthermore, the parties have stipulated that "[n]o bill or resolution was introduced that would have added any condition to the availability of the new [s]ection 2057 deduction other than those contained in the statute itself during the period between passage of the TRA and adjournment on October 18, 1986."

Willametta K. Day died on September 29, 1985. Because of an extension of the filing deadline not at issue here, her estate tax return was not due until December 29, 1986. As a matter of timeliness, the Day estate was potentially eligible for the ESOP proceeds deduction contained in section 2057.

Carlton was executor of the Day estate. He reviewed the TRA and determined that it was in the interest of the estate to utilize the new ESOP proceeds deduction. The parties have stipulated that in *specific reliance on the newly enacted section 2057*, Carlton purchased 1,500,000 shares of MCI stock on December 10, 1986 at an average price of $7.47 per share, for a total price of $11,206,000. Carlton chose to buy MCI shares because the trustee of the MCI ESOP had expressed an interest in purchasing MCI shares. At the time Carlton bought the shares, however, the MCI ESOP had not entered into any legally binding agreement to buy them from him; hence, the estate bore the risk of loss if the market in MCI stock declined. Two days later, the MCI ESOP agreed to buy the shares from the estate at $7.05 per share, which was about 26 cents *below* the mean market price that day, as well as below the price at which the shares were purchased. As part of the agreement, the MCI ESOP provided documentation

that it was a qualifying ESOP as required under section 2057. *See* 26 U.S.C. § 2057(e). The total sale price was $10,575,000, or $631,000 below Carlton's purchase price. The government concedes that Carlton would not have sold the shares at a discount—and consequently the MCI ESOP would not have been able to acquire shares at a discount—if not for the section 2057 deduction.

On December 29, 1986, Carlton duly filed the estate tax return, in which he deducted $5,287,500 from the gross estate pursuant to the ESOP proceeds deduction. On behalf of the estate, Carlton paid a net estate tax of $18,752,250.

On January 5, 1987, the Internal Revenue Service ("IRS") issued an advance version of Notice 87-13, which stated, inter alia, that "[p]ending the enactment of clarifying legislation," the IRS would not recognize a deduction pursuant to section 2057 unless the decedent had "directly owned" the securities before death ("the decedent ownership requirement"). Notice 87-13 was formally published on January 26, 1987. The government concedes that the decedent ownership requirement announced in Notice 87-13 was not contained in section 2057 as originally enacted in 1986, was not contained in any amendments to the TRA passed before the 99th Congress adjourned, nor was it in any of the proposed technical and clerical amendments to the TRA considered by the 99th Congress.

On February 26, 1987, a bill was introduced in the new 100th Congress to enact into law the decedent ownership requirement as announced in Notice 87-13 ("the 1987 amendment"). The bill eventually became law on December 22, 1987, and applied the decedent ownership requirement retroactively as if

the TRA as originally enacted had contained such a requirement. *See* Pub.L. No. 100-203 § 10411,[2] 101

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[2] SEC. 10411. CONGRESSIONAL CLARIFICATION OF ESTATE TAX DEDUCTION FOR SALES OF EMPLOYER SECURITIES.

(a) *Intent of Congress in Enacting Section 2057 of the Internal Revenue Code of 1986.*—Section 2057 (relating to sales of employer securities to employee stock ownership plans or worker-owned cooperatives) is amended by redesignating subsections (d), (e), and (f) as subsections (e), (f), and (g), respectively, and by inserting after subsection (c) the following new subsection:

(d) *Qualified Proceeds From Qualified Sales.*—

(1) *In general.*—For purposes of this section, the proceeds of a sale of employer securities by an executor to an employee stock ownership plan or an eligible worker-owned cooperative shall not be treated as qualified proceeds from a qualified sale unless—

(A) the decedent directly owned the securities immediately before death, and

(B) after the sale, the employer securities—

(i) are allocated to participants, or

(ii) are held for future allocation in connection with

(I) an exempt loan under the rules of section 4975, or

(II) a transfer of assets under the rules of section 4980(c)(3).

(2) *No substitution permitted.*—For purposes of paragraph (1)(B), except in the case of a bona fide business transaction (e.g., a substitution of employer securities in connection with a merger of employers), employer securities shall not be treated as allocated or held for future allocation to the extent that such securities are allocated or held for future allocation in substitution of other employer securities that had been allocated or held for future allocation.

(b) *Effective Date.*—The amendments made by subsection (a) shall take effect as if included in the amendments made by section 1172 of the Tax Reform Act of 1986.

Stat. 1330, 1330-432 (1987). The 1987 amendment was labeled a "Congressional Clarification of Estate Tax Deduction for Sales of Employer Securities" and its legislative history included a Committee Report statement:

> As drafted, the estate tax deduction was significantly broader than what was originally contemplated by Congress in enacting the provision. The committee believes it is necessary to conform the statute to the original intent of Congress in order to prevent a significant revenue loss under the [TRA].

H.R.Rep. No. 100-391(II), 100th Cong., 1st Sess. 1045 (1987), *reprinted in* 4 U.S.C.C.A.N. 2313-1, 2313-661 (1987).

The Day estate's tax return was audited, and the IRS determined a deficiency of $3,385,333. The net deficiency attributable to the disputed ESOP proceeds deduction was $2,501,161. Carlton does not dispute the remaining deficiency.

Carlton paid the total deficiency plus $996,953.18 in interest. On July 3, 1989, he filed a refund claim for that part of the deficiency attributable to the ESOP proceeds deduction. The IRS denied the refund claim. On October 11, 1990, Carlton filed a refund action in district court for $2,501,161 plus interest, costs, and attorneys' fees.

Carlton moved for summary judgment on stipulated facts, and the government moved to dismiss with prejudice, which the district court construed as a motion for summary judgment. The parties agreed to an order narrowing the potential issues in controversy. The government conceded that the estate was entitled to the ESOP proceeds deduction under sec-

tion 2057 as passed in 1986, and that if the 1987 amendment could not be retroactively applied consistent with due process, that Carlton was entitled to judgment. Carlton conceded that if the 1987 amendment could be retroactively applied to his transaction, the estate would not be entitled to the ESOP proceeds deduction, that there would be no other basis for claiming the refund, and that the government would be entitled to judgment.

The district court granted the government's motion for summary judgment. The district court determined that the retroactive application of the 1987 amendment to the MCI ESOP transaction did not violate due process because the 1987 amendment did not impose a "wholly new tax." The district court also rejected Carlton's Contract Clause and Takings Clause arguments, and Carlton does not press those points on appeal.

II

Whether a statute may be applied retroactively consistent with the Due Process Clause is a question of law, and thus we review the district court's determination on this issue de novo. *Licari v. Commissioner*, 946 F.2d 690, 692 (9th Cir. 1991).

III

A

Over the past half-century the Supreme Court has consistently stated a single standard to determine if a tax statute may be applied retroactively consistent with the Due Process Clause.[3] Courts "must 'consider

[3] Under long-standing judicial construction, the Ex Post Facto Clause does not apply here because this is not a criminal

the nature of the tax and the circumstances in which it is laid before it can be said that its retroactive application is so harsh and oppressive as to transgress the constitutional limitation.'" *United States v. Hemme*, 476 U.S. 558, 568-69, 106 S.Ct. 2071, 2078, 90 L.Ed.2d 538 (1986) (quoting *Welch v. Henry*, 305 U.S. 134, 147, 59 S.Ct. 121, 125, 83 L.Ed. 87 (1938)); *accord United States v. Darusmont*, 449 U.S. 292, 299, 101 S.Ct. 549, 553, 66 L.Ed.2d 513 (1981) (per curiam) (court's inquiry is "whether a particular tax is so harsh and oppressive as to be a denial of due process").[4] Outside of the tax context, the constitutional standard is often stated differently: a retroactive application of a statute must be "arbitrary and irrational" to violate due process. *See Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1, 15, 96 S.Ct. 2882, 2892, 49 L.Ed.2d 752 (1976). The Supreme Court has made clear, however, that the "harsh and oppressive" standard used in the tax context "does not differ from the prohibition against arbitrary and irrational legislation that

prosecution. "Although the Latin phrase '*ex post facto*' literally encompasses any law passed 'after the fact,' it has long been recognized by this Court that the constitutional prohibition on *ex post facto* laws applied only to penal statutes which disadvantage the offender affected by them." *Collins v. Youngblood*, 497 U.S. 37, ——, 110 S.Ct. 2715, 2718, 111 L.Ed.2d 30 (1990) (citing *Calder v. Bull*, 3 U.S. (3 Dall.) 386, 1 L.Ed. 648 (1798)). *See also Valley Wood Preserving, Inc. v. Paul*, 785 F.2d 751, 754 (9th Cir. 1986) ("The ex post facto clause is limited to criminal proceedings and therefore has no application [to a land use ordinance].").

[4] It can hardly be said that these 1981 and 1986 cases, upon which we rely, "reach back to the *Lochner* era." *See* dissent at 1062.

we clearly enunciated in *Turner Elkhorn.*" *Pension Benefit Guaranty Corp. v. R.A. Gray & Co.,* 467 U.S. 717, 733, 104 S.Ct. 2709, 2720, 81 L.Ed.2d 601 (1984).

We are instructed to "consider the nature of the tax and the circumstances in which it is laid." We "perceive no . . . rigid standard of constitutionality in the decided cases. . . . We are guided, rather, by the more flexible criteria delineated by the Supreme Court in Welch v. Henry. . . ." *Purvis v. United States,* 501 F.2d 311, 313 (9th Cir.1974) (quotations omitted), *cert. denied,* 420 U.S. 947, 95 S.Ct. 1329, 43 L.Ed.2d 425 (1975). Accordingly, we reject the notion of a per se rule that tax statutes can *never* be retroactively applied. The Supreme Court has "made clear that some retrospective effect is not necessarily fatal to a revenue law." *Hemme,* 476 U.S. at 568, 106 S.Ct. at 2077. Thus retroactivity alone will not condemn a congressional enactment.

By the same token, we also reject the notion of a per se rule that tax statutes can *always* be retroactively applied so long as they do not enact a "wholly new" tax. The Supreme Court's two most recent decisions regarding retroactivity challenges to to tax statutes, *Hemme* and *Darusmont,* did not involve wholly new taxes. Despite that fact, the Court engaged in a thorough analysis of the circumstances of each retroactive application before making its determination of constitutionality. This clearly indicates that retroactive application of the tax laws is not "automatically" permitted so long as a wholly new tax is not involved.

Thus, we consider whether, under "the circumstances in which it is laid," the retroactive application of the 1987 amendment of section 2057 to the

MCI ESOP transaction is "so harsh and oppressive" as to violate due process. An examination of previous challenges to the constitutionality of the retroactive application of tax statutes helps to elucidate the factors we must consider in our determination.

In *Nichols v. Coolidge,* 274 U.S. 531, 47 S.Ct. 710, 71 L.Ed. 1184 (1927), the Supreme Court held a retroactive application of the federal estate tax to be unconstitutional. Mrs. Coolidge had transferred property to a trust in 1907. Income on the trust was to be paid to Mrs. Coolidge and her husband, and after they had both died the corpus of the trust was to be divided among Mrs. Coolidge's children or their representatives. In 1919, Congress amended the federal estate tax to include within its ambit transfers made prior to death that were " 'intended to take effect in possession or enjoyment at or after . . . death.' " *Id.* at 539, 47 S.Ct. at 712 (quoting Act of February 24, 1919, § 402(c)). Such transfers were to be taxed at their value at the time of the transferor's death. Congress also expressly stated that such provision applied "whether such transfer or trust is made or created before or after the passage of this Act." *Id.* Mrs. Coolidge died in 1921 and the Commissioner of Internal Revenue sought to include within the gross taxable estate the present value of the trust corpus. Mrs. Coolidge, of course, had no notice that the trust corpus would be taxed as part of her estate when she created the trust in 1907. The Court also emphasized that "[a]n excise is prescribed, but the amount of it is made to depend upon past lawful transactions, not testamentary in character and beyond recall." *Id.* at 542, 47 S.Ct. at 714-15. Thus, the Court concluded that the retroactive application of the 1919 amendment was "so

arbitrary and capricious as to amount to confiscation and offend the Fifth Amendment." *Id.*

The next Term, the Supreme Court again faced a challenge to the retroactive application of a federal tax statute. In *Blodgett v. Holden*, 275 U.S. 142, 48 S.Ct. 105, 72 L.Ed. 206 (1927), four members of the Court viewed a retroactive application of the federal gift tax as violative of due process.[5] Blodgett made gifts in January 1924. The gift tax provision in question was presented to Congress for consideration on February 25, 1924, and approved on June 2, 1924. The plurality pointed out that the gifts had been made before the new statute was even pending before Congress. It concluded that "[i]t seems wholly unreasonable that one who, in entire good faith and without the slightest premonition of such consequence, made absolute disposition of his property by gifts should thereafter be required to pay a charge for so doing." *Id.* at 147, 48 S.Ct. at 106 (opinion of McReynolds, J.).

Later in the same Term, the Court revisited the question of the retroactive application of the 1924 federal gift tax legislation. In *Untermyer v. Anderson*, 276 U.S. 440, 48 S.Ct. 353, 72 L.Ed. 645 (1928), the gift was made on May 23, 1924. Hence, unlike in *Blodgett*, the gift was made after Congress had begun consideration of the legislation, although still before such legislation was enacted. Nonetheless, the

[5] This opinion by Justice McReynolds was joined by Chief Justice Taft and Justices Van Devanter and Butler. Justice Holmes, joined by Justices Brandeis, Sanford and Stone, was of the view that the statute could be read to not apply retroactively, thus avoiding the constitutional question. No vote is recorded for Justice Sutherland, and thus the Court was evenly divided on this issue.

Court still found the retroactive application to offend due process.

> The mere fact that a gift was made while the bill containing the questioned provisions was in the last stage of progress through Congress we think is not enough to differentiate this cause from [*Blodgett*] and to relieve the legislation of the arbitrary character there ascribed to it. . . . The taxpayer may justly demand to know when and how he becomes liable for taxes—he cannot foresee and ought not to be required to guess the outcome of pending measures. The future of every bill while before Congress is necessarily uncertain.

Id. at 445-46, 48 S.Ct. at 354.

This court too has held that a federal tax as applied was unconstitutionally retroactive. *See Wheeler v. Commissioner*, 143 F.2d 162, 168 (9th Cir.1944), *rev'd on other grounds*, 324 U.S. 542, 65 S.Ct. 799, 89 L.Ed. 1166 (1945). In reliance on the Revenue Act of 1938, the shareholders of the John H. Wheeler Company dissolved the corporation and distributed its assets proportionately among themselves. Under the Revenue Act of 1938, the capital gains of the dissolved corporation were measured for tax purposes as if the corporation had bought all its assets at market value. That is, the basis of certain assets was taken as the market value at the time the assets were transferred from shareholders to the corporation. The Second Revenue Act of 1940, however, purported to change the rule retroactively for corporations liquidated under the Revenue Act of 1938. Under the 1940 Act, the corporation assumed the

transferor-shareholder's basis, rather than taking as its basis the market value at the time of transfer. This court held that the Second Revenue Act of 1940 had not "come within the next session of the legislature [following passage of the 1938 Act] or within a reasonable length of time" and hence could not be retroactively applied to the Wheelers' 1938 corporate dissolution consistent with due process. *Id.* at 168.

We have recently stated that "[f]ederal courts have long been hostile to legislation that interferes with settled expectations." *Licari*, 946 F.2d at 693. Still, it cannot be gainsaid that the modern trend has been against successful challenges to retroactive applications of the tax statutes. In three modern cases, the Supreme Court has rejected due process challenges to retroactive applications of revenue acts.

In *Welch v. Henry*, 305 U.S. 134, 59 S.Ct. 121, 83 L.Ed. 87 (1938), the challenged revenue act retroactively imposed a tax on certain dividend income that had formerly been excluded from taxation. There was no indication that the taxpayer had incurred any extra expenses or in any other way changed his conduct in reliance on the tax law as it stood before retroactive amendment. In holding the retroactive tax constitutional, the Court observed, "[w]e can not assume that stockholders would refuse to receive corporate dividends even if they knew that their receipt would later be subjected to a new tax or to the increase of an old one." *Id.* at 148, 59 S.Ct. at 126. The Court stated, however, that a different case would be presented where a transaction was taxed that was "completely vested before the enactment of the taxing statute," and "the nature or amount of the tax could not reasonably have been anticipated by the taxpayer at the time of the particular voluntary act which the statute later made the taxable event." *Id.* at 147, 59 S.Ct. at 125.

In *United States v. Darusmont*, 449 U.S. 292, 101 S.Ct. 549, 66 L.Ed.2d 513 (1981) (per curiam), the taxpayer unsuccessfully challenged the retroactive application of a change in the minimum tax that increased the tax on an already completed sale of real property. Far from relying on the pre-amendment law, the taxpayer "conceded . . . that when he was considering the various ways in which he could dispose of the Texas property, he was *not aware* of the existence of the minimum tax." *Id.* at 295, 101 S.Ct. at 551 (emphasis added). The Court further observed that the taxpayer was "hardly in a position to claim surprise at the 1976 amendments to the minimum tax. The proposed increase in rate had been under public consideration for almost a year before its enactment." *Id.* at 299, 101 S.Ct. at 553. Also significant was that the 1976 amendments merely "decreas[ed] the allowable exemption and increas[ed] the percentage rate of tax." *Id.* at 300, 101 S.Ct. at 553.

In *United States v. Hemme*, 476 U.S. 558, 106 S.Ct. 2071, 90 L.Ed.2d 538 (1986), the retroactive application of a transitional rule[6] to gifts made before its enactment was challenged on due process grounds. In concluding that due process was not violated, the Court put great weight on the fact that the taxpayers were "no worse off than they would have been without the enactment of the Act." *Id.* at 570, 106 S.Ct. at 2079. The Court noted that even under

[6] The transitional rule was "enacted to bridge the old and new regimes for the federal taxation of gifts and estates." *Hemme*, 476 U.S. at 560, 106 S.Ct. at 2073.

the retroactive operation of the transitional rule, the taxpayers "still have paid estate taxes of $655.16 *less* than they would have paid had the 1976 Act never been passed" and that accordingly "the retroactive aspect of the law would not be said to be oppressive or inequitable." *Id.* at 571, 106 S.Ct. at 2079. The Court also found it significant that "§ 2035 had long been in effect at the time [the decedent] made his gift, and it is § 2035 that contains the principal retroactive feature involved in this case, requiring the estate to reach back and embrace a gift made over two years previously." *Id.*

This court recently decided a challenge to an increase in the penalty rate from 10% to 25% for underpayment of tax liability, retroactively applied to tax returns filed before the date of enactment where penalties had not yet been assessed as of the enactment date. *Licari*, 946 F.2d at 692. We concluded that the retroactive aspect of the statute was rational because it served to make those who were trying to cheat "reimburs[e] the government for [the] heavy burden of investigative and prosecutorial costs incident to ferreting out tax underpayment." *Id.* at 695. We were careful to point out, however, that:

> [h]ere, *we are not presented with a case in which an individual acted in accordance with the law as it stood at the time* only later to be subjected to a penalty; instead, those subjected to the increased penalties, like the Licaris, knew at the time that they filed their returns that they were not acting in accordance with the law and could be subjected to a fine. . . . Under these circumstances, we do not find imposition of the increased penalty unduly "harsh and oppressive."

Id. at 695 (emphasis added).

B

From these cases, two circumstances emerge as of paramount importance in determining whether the retroactive application of a tax is unduly harsh and oppressive. First, did the taxpayer have actual or constructive notice that the tax statute would be retroactively amended? Second, did the taxpayer rely to his detriment on the pre-amendment tax statute, and was such reliance reasonable? We address each question in turn.

It is undisputed that Carlton had no actual notice of the 1987 amendment imposing the decedent ownership requirement when he completed the MCI ESOP transaction in 1986. Nor is there any basis upon which Carlton could have had constructive notice of the future imposition of the decedent ownership requirement. The Day estate completed its transaction before the end of December 1986. The IRS first proposed that section 2057 be amended to include a decedent ownership requirement on January 5, 1987. The bill that included the 1987 amendment was introduced in Congress on February 26, 1987. Moreover, the government concedes that the decedent ownership requirement was not "identified in the proposed technical and clerical amendments discussed before Congress adjourned," and was not "added to the statute (although other changes to the TRA were made) before Congress adjourned" on October 18, 1986. Hence, no act of the executive or legislative branch would have given any forewarning of the

1987 amendment at the time the MCI ESOP transaction occurred.

The government argues, however, that the legislative history of the TRA should have put Carlton on constructive notice that Congress had intended to include a decedent ownership requirement in section 2057, and that an amendment imposing such a requirement was surely in the offing. The government, however, can only point to two passing references in congressional documents in support of its view. Both of these references merely state that the ESOP proceeds deduction would be *available* to a decedent who sold his company to an employee group. The government can point to no place in the legislative history that states that the ESOP proceeds deduction would be *limited* to such a situation.

Further, one of these passing references was in a pamphlet written by the staff of the Joint Committee on Taxation in September 1985. The pamphlet does not purport to speak for Congress or even a congressional committee, and was prepared over a year before passage of the TRA. Its value as legislative history is doubtful. The other passing reference is a floor statement made by Senator Russell Long, which was at best ambiguous.[7] We have no trouble concluding that these two fleeting references—each of which merely stated that section 2057 would encourage decedents to sell their own companies to an ESOP —did not give constructive notice to Carlton that an amendment imposing a decedent ownership requirement would be forthcoming.

[7] Interestingly, while the government argues that this statement gave constructive notice to Carlton, the government itself was apparently unaware of it at the time it filed its brief and only brought it to our attention on the eve of oral argument.

Next, we turn to the second important factor, whether Carlton reasonably and detrimentally relied on section 2057 as enacted in 1986. That Carlton specifically relied on the ESOP proceeds deduction contained in the new section 2057 in deciding to pursue the MCI transaction is undoubted. Indeed, the government has so stipulated. While this fact is uncontested, it should not be overlooked. The very fact that Carlton engaged in a costly transaction for no other reason than the inducement provided by the new section 2057 makes this case significantly different from those rejecting a due process challenge to a retroactively applied revenue law.

Indeed, to say that the estate merely "relied" on section 2057 understates the circumstances of this case. The federal government has long sought to promote employee ownership of shares in their employers. Section 2057 was enacted to induce taxpayers to sell shares at a discounted price to an ESOP, thus furthering the public policy of employee ownership. As intended, the Day estate succumbed to the lure and sold shares to the MCI ESOP at a substantial discount. Section 2057 worked. An ESOP was able to buy more shares at a lower price than before. Then, when the private actor had completed the socially desirable action of selling shares at a discount to an ESOP, the government reneged on its end of the deal. It was too late for Carlton to undo his sale to the MCI ESOP. The $631,000 was gone forever, irretrievable.

The government urges, however, that while Carlton's reliance on the ESOP proceeds deduction is undoubted, it was not reasonable. At the core of this argument is the notion that section 2057 as originally enacted was such a windfall, any reasonable taxpayer would have known it was "too good to be true." We

flatly reject the government's premise that a taxpayer cannot rely on the clear and unequivocal text of the tax code, but instead must speculate on the unspoken and inchoate intentions of Congress.

Moreover, viewed in the context of the other huge tax incentives that Congress has created to encourage the development of ESOPs, section 2057 should not have raised any eyebrows, even as first enacted in 1986. According to the Joint Committee on Taxation,

> [t]he tax expenditure for qualified plans is the largest single item of tax expenditures. For the fiscal year 1986, the tax expenditure for employer maintained qualified plans (including Keogh plans) is estimated to be \$56.8 billion and this expenditure is projected to increase to \$88.9 billion for fiscal year 1990.

Staff of Joint Comm. on Taxation, 99th Cong., 1st Sess., Tax Reform Proposals: Tax Treatment of Employee Stock Ownership Plans (ESOPs) 21 n. 29 (Comm. Print 1985). The total annual tax expenditure of section 2057 if it had *not* been amended in 1987 was estimated by the Joint Committee on Taxation at \$1.4 billion. *See* 133 Cong. Rec. H845 (Feb. 26, 1987) (statement of Rep. Rostenkowski citing the Joint Comm. on Taxation); *id.* at S2532 (statement of Sen. Bentsen citing the Joint Comm. on Taxation). Although ESOPs are just one type of "qualified plan," a term which also includes pension and profit-sharing plans, this tax expenditure of \$1.4 billion does not appear incredible in the context of a total tax expenditure to promote employee investment of \$56.8 billion. Thus, even if it were reasonable to expect that before a taxpayer would take a deduction plainly available to him under the tax code, he

would research the estimated tax expenditure associated with such deduction, the tax expenditure created by the ESOP proceeds deduction as originally enacted was entirely plausible.

Carlton had little reason to think Congress had made a drafting error. After all, the ESOP proceeds deduction was not added to the TRA in a frenzied last minute effort. Section 2057 had first been proposed over two and a half years before the TRA was finally passed. As approved by the Senate Finance Committee in March 1984, section 2057 did not have a decedent ownership requirement. Sen. Comm. on Finance, 98th Cong., 2d Sess., 2 Deficit Reduction Act of 1984, Statutory Language of Provisions Approved by the Committee on March 21, 1984, at 338 (Comm. Print 1984). Thus, it cannot be seriously argued that the decedent ownership requirement was inadvertently omitted in a last minute drafting error.

Congress has given several substantial tax incentives to ESOPs over the years. When a bank loans money to an ESOP to finance the purchase of shares, half of the interest income from such loans is excluded from taxable income. *See* 26 U.S.C. § 133. Taxpayers who sell shares to an ESOP may defer for tax purposes the recognition of any capital gain on such sale. *See* 26 U.S.C. § 1042. In this context, section 2057's provision allowing half of the proceeds of a sale of shares to an ESOP to be excluded from the taxable estate would not have appeared out of line.

The government nevertheless argues that any reliance by the estate on the new section 2057 was not truly detrimental in any event. This argument has two aspects. First, the government argues that the availability of any deduction under the tax code is an act of legislative grace, and that the 1987 amendment

imposing the decedent ownership requirement simply restored the estate to the position it would have been in had Congress not made the "mistake" of passing section 2057 in 1986 without the decedent ownership requirement. This is simply not correct. The estate essentially "paid" $631,000 (plus transactions costs such as brokerage and attorney fees) to receive the $2.5 million reduction in tax liability. Unlike *Welch*, where the tax preference for Wisconsin corporations having been ended the taxpayer was merely restored to the position he would have been in had such preference never been enacted, here, the taxpayer is *not* restored to the status quo ante, but suffers a loss. It is true that the payment of the $2.5 million in taxes makes the estate's *tax liability* no worse than it would have been if the ESOP proceeds deduction had never been enacted in the first place. But this begs the question. It fails to account for the actual loss suffered by the estate. To truly return the estate to the status quo ante, the government would have to pay it $631,000. We are persuaded that this is a critical distinction from *Hemme* where, even with the retroactive application of the new tax statute, the taxpayer was still better off than the would have been under the old regime.

Second, the government contends that a loss by the estate was not a prerequisite under section 2057 to qualify for the ESOP proceeds deduction, and so should not be considered in determining whether retroactive application of the decedent ownership requirement is unduly harsh and oppressive. That is, selling the shares to the ESOP *at a discount* from the market price is not one of the statutorily defined requirements to qualify for the ESOP proceeds deduction.

One need not be an economist, however, to perceive that in practice the only way to have obtained the deduction was for the estate to offer to "share" it with the other party necessary to the transaction, the ESOP. Under section 2057, the estate must file with the IRS certification from the ESOP that the ESOP meets certain requirements. *See* 26 U.S.C. § 2057 (e). Because the ESOP must provide such certification, it necessarily knows the circumstances under which the sale is being made and the substantial tax deduction the estate will be receiving. Moreover, there is no way of going around the ESOP; its cooperation is essential. In this situation, it is manifest that any rational ESOP can and will demand some part of the tax break in the form of a discounted share price. The MCI ESOP had to have some incentive to deal with Carlton, given the extra paperwork required, rather than just purchase its shares on the open market. Selling the shares at a discount from the market price was not an error or miscalculation on Carlton's part, but instead a necessary concession to complete the deal.

We believe that the estate's reliance on the plain language of section 2057 was reasonable in light of the lack of any indication that an amendment was in the offing and in the context of the large tax incentives Congress has given to ESOPs. Further, the detriment to the estate is obvious. The 1987 amendment did not merely restore the status quo before the TRA. The estate was out $631,000.

The government argues that the MCI ESOP transaction was a sham, that it had no substance. We disagree. The substance was in the transfer of wealth from the Day estate to the MCI ESOP. The

Day estate was $631,000 poorer after the transaction than it was before. The MCI ESOP now owns more shares than it would have had it only been able to purchase shares on the open market. The permanently changed positions of the parties show that the transaction had substance and reality.

We do not doubt the power of Congress to apply legislation retroactively to the time such legislation was introduced, or even to the time such legislation was proposed by the executive branch. *See Purvis*, 501 F.2d at 313-14 (retroactive application of "interest equalization tax" on American purchases of foreign securities to the time when first proposed by the President does not violate due process). During this time period, the taxpayer is on notice that a change in law is forthcoming. The government has a strong interest in capturing within its taxing powers transactions deliberately rushed through in anticipation of a pending change of law. Our conclusion would likely be entirely different if Carlton had engaged in his transaction after January 5, 1987. *See Ferman v. United States*, 790 F.Supp. 656 (E.D.La. 1992) (rejecting claim that decedent ownership requirement was unconstitutionally applied to transaction in February 1987).

Having considered the nature of the 1987 amendment and the circumstances in which it was laid, we conclude that, as applied here, such amendment is "so harsh and oppressive as to transgress the constitutional limitation." Carlton had no notice, actual or constructive. The estate entered into a transaction that cost it over $600,000, based solely on the inducement of a tax deduction the government now wants to take away.

IV

We hold that the 1987 amendment to the federal estate tax imposing a decedent ownership requirement on the ESOP proceeds deduction formerly contained at 26 U.S.C. § 2057, as applied to the transaction at issue here, violated the Due Process Clause of the Fifth Amendment. The parties have stipulated that if such amendment could not be retroactively applied to the transaction here consistent with the Constitution, "then the taxpayer is entitled to judgment as sought in the complaint." Accordingly, we reverse the judgment of the district court and remand with instructions to enter judgment in favor of the plaintiff.

REVERSED and REMANDED with INSTRUCTIONS.

NORRIS, Circuit Judge, dissenting:

The majority recognizes that "the modern trend has been against successful challenges to retroactive applications of the tax statutes." Majority at 1057. Indeed, in order to find Supreme Court precedent for striking down retroactive taxation, the majority opinion, like the petitioner's brief, was forced to reach back to the *Lochner* era. My reading of contemporary case law leads me to a different conclusion: Congress did not offend the constitutional requirement of due process when it retroactively applied the "decedent ownership requirement" to an estate tax provision encouraging Employee Stock Ownership Plans (ESOPs). I accordingly dissent.

In regulating economic activity, Congress enjoys wide latitude to legislate retroactively. The Supreme Court explains that

> the strong deference accorded legislation in the field of national economic policy is no less applicable when that legislation is applied retroactively. Provided that the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches. . . .

Pension Benefit Guaranty Corp. v. R.A. Gray & Co., 467 U.S. 717, 729, 104 S.Ct. 2709, 2717-18, 81 L.Ed. 2d 601 (1984). This principle applies with full force to the tax laws, where courts may step in only when " 'retroactive application is so harsh and oppressive as to transgress the constitutional limitation.' " *United States v. Hemme*, 476 U.S. 558, 568-69, 106 S.Ct. 2071, 2077, 90 L.Ed.2d 538 (1986) (quoting *Welch v. Henry*, 305 U.S. 134, 147, 59 S.Ct. 121, 125, 83 L.Ed. 87 (1938)). Measured against this high standard, the 1987 amendment to the Tax Reform Act of 1986 should be upheld.

The facts of *Welch v. Henry* provide an appropriate starting point for interpreting the "harsh and oppressive" standard that the opinion articulates. The taxpayer's income in that case derived mostly from dividends paid by corporations doing a majority of their business in Wisconsin. *Welch*, 305 U.S. at 141, 59 S.Ct. at 122. Wisconsin's income tax statutes treated such dividend income extremely favorably until, in 1935, the state imposed additional taxes, to be applied retroactively to dividends paid in 1933 and 1934. *Id.* at 143, 59 S.Ct. at 124. Although the Court had previously struck down retroactive taxes on gifts, *see Nichols v. Coolidge*, 274 U.S. 531,

47 S.Ct. 710, 71 L.Ed. 1184 (1927), *Blodgett v. Holden*, 275 U.S. 142, 48 S.Ct. 105, 72 L.Ed. 206 (1927), *Untermyer v. Anderson*, 276 U.S. 440, 48 S.Ct. 353, 72 L.Ed. 645 (1928), it upheld this statute on the basis that "a tax on the receipt of income is not comparable to a gift tax," but more properly resembles property taxes and benefit assessments of real estate, where retroactivity had been found appropriate. *Id.* 305 U.S. at 147-48, 59 S.Ct. at 125-26. The Court reasoned that bestowing a gift is the "voluntary act of the taxpayer," which it contrasted with receiving corporate dividends: "We can not assume that stockholders would refuse to receive corporate dividends even if they knew that their receipt would later be subjected to a new tax or to the increase of an old one." *Id.* Because the decision to invest in stocks whose dividends receive favorable tax treatment is, of course, voluntary, the distinction between the taxpayer in *Welch* and those in *Nichols*, *Blodgett*, and *Untermyer* lies in the difference between Welch's economic and the others' eleemosynary motives for the acts that gave rise to tax liability. Welch's dividends were a form of consideration in exchange for his investment in Wisconsin corporations, and receipt of consideration was, in the Court's sense of the word, involuntary.

Carlton's case closely resembles Welch's. Carlton structured the financial affairs of Mrs. Day's estate to take advantage of favorable tax treatment for sales of stock to ESOPs. Likewise, Welch's portfolio had been structured to exploit the special treatment accorded dividends from Wisconsin corporations. In Carlton's case, as in Welch's, the taxing authority that had created the special tax benefits grew con-

cerned about their drain on the public fisc and retroactively eliminated them. In Welch's case, the retroactive law was a sharp departure from a long history of favorable treatment for investments in Wisconsin corporations. *Welch*, 305 U.S. at 142-43, 59 S.Ct. at 123. Carlton's case is arguably less sympathetic because the retroactive law, in closing a loophole in the new ESOP deduction provision, merely restored the status quo that Carlton faced a year earlier.

Cases decided since *Welch* have upheld retroactive taxes on a variety of economic transactions, sharply limiting the scope of the *Lochner*-era cases. *See, e.g.*, *United States v. Hemme*, 476 U.S. 558, 106 S.Ct. 2071, 90 L.Ed.2d 538 (1986) (retroactive application of the transitional rule for federal gift and estate taxes upheld); *United States v. Darusmont*, 449 U.S. 292, 101 S.Ct. 549, 66 L.Ed.2d 513 (1981) (per curiam) (retroactive increase in the minimum tax upheld); *Wiggins v. Commissioner*, 904 F.2d 311 (5th Cir.1990) (upheld retroactive exclusion of investment tax credit recapture when calculating alternative minimum tax); *Estate of Ekins v. Commissioner*, 797 F.2d 481 (7th Cir.1986) (retroactive repeal of an estate tax exclusion for life insurance policies upheld); *Fein v. United States*, 730 F.2d 1211 (8th Cir.), *cert. denied*, 469 U.S. 858, 105 S.Ct. 188, 83 L.Ed.2d 121 (1984) (same); *Estate of Ceppi v. Commissioner*, 698 F.2d 17 (1st Cir.1983), *cert. denied*, 462 U.S. 1120, 103 S.Ct. 3088, 77 L.Ed.2d 1350 (1983) (retroactive repeal of estate tax exclusion upheld); *Westwick v. Commissioner*, 636 F.2d 291 (10th Cir.1980) (retroactive changes in the minimum tax upheld in spite of detrimental reliance); *Purvis v. United States*, 501 F.2d 311 (9th Cir.), *cert. denied*, 420 U.S. 947, 95 S.Ct. 1329, 43 L.Ed.2d

425 (1975) (interest equalization tax on foreign stock acquisitions may be retroactively applied); *First National Bank in Dallas v. United States*, 420 F.2d 725, 190 Ct.Cl. 400 (1970) (same); *Sidney v. Commissioner*, 273 F.2d 928 (2d Cir.1960) (Friendly, J.) (retroactive taxation of gains realized from collapsible corporations upheld).

Most of these cases have limited *Nichols*, *Blodgett*, and *Untermyer* to their facts, or at least to retroactive imposition of a wholly new tax, as opposed to a change in the base or rate of an existing tax. *Hemme*, 476 U.S. at 568, 106 S.Ct. at 2077; *Darusmont*, 449 U.S. at 299, 101 S.Ct. at 553; *Wiggins*, 904 F.2d at 314; *Estate of Ekins*, 797 F.2d at 484; *Fein*, 730 F.2d at 1213; *Estate of Ceppi*, 698 F.2d at 21; *Westwick*, 636 F.2d at 292; *First Nat'l Bank in Dallas*, 420 F.2d at 730 n. 8; *Sidney*, 273 F.2d at 932. The Ninth Circuit decided *Purvis v. United States* on the narrower ground that a presidential speech proposing the retroactive tax had put the taxpayer on notice of the subsequent change, so that retroactive application was not "harsh and oppressive." 501 F.2d at 314-15.

The Supreme Court and our sister circuits have made clear, however, that constructive notice to the taxpayer is usually implied for a change in the rate or basis of an existing tax. In the words of the Seventh Circuit, "a change in the tax rate is considered by its very nature to be reasonably foreseeable." *Estate of Ekins v. Commissioner*, 797 F.2d 481, 484 (7th Cir. 1986). "Legislative changes are to be expected, and the taxpayer assumes the risk that the tax burden on a particular transaction may increase pursuant to Congress' continual responsibility to carry out the necessary policies of taxation." *Id.* at

483 (citing *Milliken v. United States*, 283 U.S. 15, 23, 51 S.Ct. 324, 327, 75 L.Ed.2d 809 (1931)). *Accord Fein v. United States*, 730 F.2d 1211, 1213 (8th Cir.), *cert. denied*, 469 U.S. 858, 105 S.Ct. 188, 83 L.Ed.2d 121 (1984). Our court once considered the point so obvious that it disposed of a challenge to retroactive repeal of an income tax loss carry-forward provision in a single paragraph. We called that tax provision "a matter of legislative grace . . . within the power of Congress to revoke" retroactively. *Miller v. Commissioner*, 115 F.2d 479, 480 (9th Cir. 1940). Under this analysis, we should imply constructive notice of the tax code amendment, which retroactively abolished the fifty percent deduction for proceeds from an ESOP stock sale but levied no wholly new taxes. The majority, in reaching a different conclusion, creates a split among the circuits, as well as a conflict with our own, older precedent.

In addition to taxes that are wholly new and therefore completely unforeseeable, the Supreme Court has suggested that retroactive taxes that "attempt to reach events [too] far in the past" are harsh and oppressive. *Welch v. Henry*, 305 U.S. 134, 148, 59 S.Ct. 121, 126, 83 L.Ed. 87 (1938). Congress has long enacted revenue laws that retroactively tax income and assets from the entire year in which the new statute is passed, and in some instances from the calendar year preceding the year of the new legislation's enactment. *United States v. Darusmont*, 449 U.S. 292, 296, 101 S.Ct. 549, 551, 66 L.Ed.2d 513 (1981) (per curiam). The coutrs have upheld this "cutomary congressional practice" as "required by the practicalities of producing national legislation." *Id.* at 297, 101 S.Ct. at 552. The circuits have split on whether retroactive taxes may reach back before

the calendar year that precedes the year of their enactment. Curative legislation, passed to effectuate the original intent of Congress, has been granted greater leeway. *See, e.g., New England Baptist Hospital v. United States*, 807 F.2d 280, 285 (1st Cir. 1986) (four years of retroactive effect upheld for curative legislation); *accord Canisius College v. United States*, 799 F.2d 18, 26-27 (2d Cir.), *cert. denied*, 481 U.S. 1014, 107 S.Ct. 1887, 95 L.Ed.2d 495 (1987); *accord Temple University v. United States*, 769 F.2d 126, 135 (3d Cir.), *cert. denied*, 476 U.S. 1182, 106 S.Ct. 2914, 91 L.Ed.2d 544 (1986); *cf. Wheeler v. Commissioner*, 143 F.2d 162, 166 (9th Cir.), *rev'd on other grounds*, 324 U.S. 542, 65 S.Ct. 799, 89 L.Ed. 1166 (1945) (tax statute with two years' retroactive application struck down). We need not reach that dispute here, however, where the period of retroactive application for the revenue measure includes the calendar year in which it was passed and only a few months of the preceding year.[1]

The majority's opinion substitutes a test much more sympathetic to the taxpayer than those that courts have used in the past. It asks (1) whether the taxpayer had actual or constructive notice of the specific retroactive provision, and (2) whether the taxpayer reasonably relied to his detriment on the tax code as written at the time of his transaction. While maximum fairness to taxpayers might argue that Congress should legislate according to this gen-

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[1] The amendment retroactively applying the decedent ownership requirement was introduced in the 100th Congress on February 26, 1987. It became law on December 22, 1987, and applied as of October 22, 1986, the day when the Tax Reform Act it modified was originally enacted.

erous standard, the Supreme Court has declined to adopt it as a requirement of Due Process.

The taxpayer in *Darusmont* suggested two tests that resemble those the majority uses here. First he asked, could the taxpayer "have altered his behavior to avoid the tax if it could have been anticipated by him at the time the transaction was effected?" 449 U.S. at 299, 101 S.Ct. at 553. The majority's inquiry into detrimental reliance is the same test more elegantly stated, but the Supreme Court rejected it as based on the old gift tax cases, which had no precedential value for retroactive taxes on income. *Id.* Detrimental reliance is essentially a creature of contract law, where the theory of promissory estoppel vests rights in a party that reasonably relies on another's promise. Restatement (Second) of Contracts § 90 (1981). Contractual analogies, the Supreme Court tells us, are inapposite in tax cases:

> '[t]axation is neither a penalty imposed on the taxpayer nor a liability which he assumes by contract. It is but a way of apportioning the cost of government among those who in some measure are privileged to enjoy its benefits and must bear its burdens. Since no citizen enjoys immunity from that burden, its retroactive imposition does not necessarily infringe due process, and to challenge the present tax it is not enough to point out that the taxable event . . . antedated the statute.'

United States v. Darusmont, 449 U.S. 292, 298, 101 S.Ct. 549, 552, 66 L.Ed.2d 513 (1981) (per curiam) (quoting *Welch v. Henry*, 305 U.S. 134, 146-47, 59 S.Ct. 121, 125, 83 L.Ed. 87 (1938)).

Darusmont's second test was whether the taxpayer lacked "actual or constructive notice" of the retroactive legislation. The Court's per curiam opinion did not directly address the appropriateness of this inquiry, as the facts of Darusmont's case indicated notice aplenty. The Court did, however, cite approvingly a couple of its earlier cases upholding retroactive taxation where notice had not been demonstrated. *Id.* 449 U.S. at 299, 101 S.Ct. at 553 (citing *Welch v. Henry*, 305 U.S. 134, 59 S.Ct. 121, 83 L.Ed. 87 (1938)), *Id.* 449 U.S. at 300, 101 S.Ct. at 553 (citing *Cooper v. United States*, 280 U.S. 409, 50 S.Ct. 164, 74 L.Ed. 516 (1930)). And two other circuits have interpreted an earlier Supreme Court case as inferring constructive notice whenever a tax code revision alters the rate or basis for an existing tax. *Estate of Ekins v. Commissioner*, 797 F.2d 481, 483 (7th Cir. 1986) (citing *Milliken v. United States*, 283 U.S. 15, 23, 51 S.Ct. 324, 327, 75 L.Ed. 809 (1931)); *accord Fein v. United States*, 730 F.2d 1211, 1213 (8th Cir.), *cert. denied*, 469 U.S. 858, 105 S.Ct. 188, 83 L.Ed.2d 121 (1984).

In any event, were I to apply the majority's test to this case, I would be less willing to find that, at the time he arranged the purchase and sale of MCI stock, Carlton lacked constructive notice that a future retroactive amendment might render the Day estate ineligible for the ESOP deduction. Nor would I find his reliance on the statute as originally passed to have been reasonable. True, the plain language of the 1986 provision allowed Carlton to benefit from the transaction he arranged. But several factors indicated that Congress would not be satisfied with its original work and might act to curtail the benefit within a short time after its enactment.

First, the available legislative history indicates that the original intent of Congress had been to allow

"stockholders to sell their companies to their employees who helped them build the company." Staff of the Joint Committee on Taxation, 99th Cong., 2d Sess., *Tax Reform Proposals: Tax Treatment of Employee Stock Ownership Plans (ESOPs)* at 37 (Comm. Print 1985). The majority correctly points out that this statement highlights a class of decedent owners, but does not *limit* the deduction to them. If, however, Congress had meant to allow any estate willing to undertake a relatively low-risk securities transaction to benefit from the ESOP proceeds deduction, then examples of decedent owners selling to their employees would be an infinitesimal proportion, not a prototypical example, of the beneficiaries of the rule. Any estate executor would have difficulty resisting the temptation to purchase securities on the open market and promptly resell them at below market to an ESOP in order to reduce estate taxes. Had Congress understood the scope of the provision it had drafted, the measure's opponents would surely have raised more important concerns than the tracing problems for life-time sales that the legislative history mentions as the chief argument against the deduction. *Id.* The estimated revenue loss from the estate tax provision as drafted—some $7 billion—was more than 20 times the $300 million loss Congress had contemplated. Appellee's Brief at 26.

Second, the statute on its face offered a benefit that appeared "too good to be true." Admittedly, a number of laws provide tax incentives to encourage the growth of ESOPs, in some cases subsidizing third parties for facilitating the transfer of employer securities to an ESOP. For example, a 1984 provision gives a taxpayer who sells an ESOP stock in a closely held corporation the right to roll over his or her

capital gains by reinvesting in other securities. 26 U.S.C. § 1042. Although this provision gives the taxpayer an incentive to sell to an ESOP rather than on the open market, it offers those who sell to ESOPs no tax advantages over those who continue to hold their original investment, and thus should cost the U.S. Treasury little. Another provision that benefits ESOPs through subsidies to third parties allows a bank to exclude from taxation fifty percent of interest income for any loan made to an ESOP. 26 U.S.C. § 133. Note that the loss to the Treasury from this provision leverages tremendous funds: At a ten percent interest rate, every nickel of tax base the Treasury loses lands a dollar in the pocket of an ESOP. In contrast, the estate tax provision that Carlton employs saps fifty cents of estate tax base without guaranteeing *any* benefit for the ESOP. True, the ESOP's bargaining leverage should enable it to shave off for itself a piece of the estate's tax benefit. But the outcome of this case, where the ESOP saved $631,000 in purchasing employer stock, while the Treasury lost $2,501,161 in estate taxes, demonstrates that the deduction as drafted offered a subsidy of a wholly different magnitude from existing provisions. Congress could more providently have underwriten ESOP stock purchases directly from the U.S. Treasury without bringing in estate executors as middlemen!

I recognize that, if this case raised a question of statutory interpretaton, neither the provision's legislative history nor its unfortunate economic effects could detract from the plain meaning of the text. *See Connecticut Nat'l Bank v. Germain,* —— U.S. ——, at ——, 112 S.Ct. 1146, at 1149, 117 L.Ed.2d 391 (1992). But this case does not require us to

interpret the 1986 statute, only to inquire whether Congress, in amending it, acted in an arbitrary and capricious manner, or "so harsh[ly] and oppressive[ly] as to transgress the constitutional limitation." *Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 733, 104 S.Ct. 2709, 2719, 81 L.Ed.2d 601 (1984). Because Congress's retroactive legislation limited the scope of a loophole that had been in effect just over one year, it did not transgress that boundary.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 91-55590

DC No. CV-90-0685-AHS

JERRY W. CARLTON, Executor of the Will of WILLAMETTA K. DAY, PLAINTIFF-APPELLANT

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLEE

ORDER

[Filed Mar. 9, 1993]

Before: ALARCON, NORRIS, and O'SCANNLAIN, Circuit Judges.

A majority of the panel has voted to deny the petition for rehearing and to reject the suggestion for rehearing en banc. Judge Norris would grant the petition for rehearing and accept the suggestion for rehearing en banc.

The full court has been advised of the en banc suggestion. An active judge requested an en banc vote, which failed to obtain a majority of the nonrecused active judges.

The petition for rehearing is DENIED and the suggestion for rehearing en banc is REJECTED.

APPENDIX C

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

SA CV 90-685 AHS (RWRx)

JERRY W. CARLTON, ETC., PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

MEMORANDUM OPINION ON ORDER GRANTING DEFENDANT'S MOTION TO DISMISS COMPLAINT AND ACTION WITH PREJUDICE AND DENYING PLAINTIFF'S MOTION FOR SUMMARY JUDGMENT

[Filed Apr. 15, 1991]

I. INTRODUCTION

On October 11, 1990, plaintiff filed his claim against the United States seeking refund of taxes paid in the amount of $2,501,161.00, plus interest and costs, including attorneys' fees. On March 27, 1991, the Court approved and filed the parties' Stipulation of Uncontroverted Facts. The parties filed memoranda of points and authorities in support of their respective positions. Oral argument was held April 8, 1991, after which the motions were taken under submission. By this Order, the Court grants defendants' motion and denies plaintiff's motion.

Because disposition of this case turns an application of law to stipulated facts and not the sufficiency of plaintiff's pleadings, the Court construes defendant's Motion to Dismiss Complaint with Prejudice as a Motion for Summary Judgment. *United States v. 1982 Sanger 24' Spetra Boat*, 738 F.2d 1043, 1046 (9th Cir. 1984) (parties' label for motion not binding on court, for the court can construe any motion to be the type proper for the relief requested). In this case, cross motions for summary judgment are appropriate because the facts are not in dispute, and the case may be resolved as a matter of law. *See e.g.*, Fed. R. Civ. P. 56(c). The parties acknowledged at the time of hearing that the procedural posture is of no moment and that the motions may be deemed cross motions for summary judgment.

II. DISCUSSION

Under the standard enunciated in *Welch v. Henry*, 305 U.S. 134, 147, 59 S.Ct. 121, 127, 83 L.Ed. 87 (1938), a retroactive tax is constitutional *unless* its "application is so harsh and oppressive as to transgress the constitutional limitation." In applying the *Welch* standard, the courts have concluded that "the application of a tax statute will not amount to a deprivation of property without due process of law if it meets two tests: the change is reasonably foreseeable *and* is only a fluctuation in the tax rate instead of a wholly new tax." *See Estate of Ekins v. C.I.R.*, 797 F.2d 481, 484-85 (7th Cir. 1986); *Fein v. United States*, 730 F.2d 1211, 1212-13 (8th Cir. 1984). Hence, because "a change in the tax rate is considered by its very nature to be reasonably foreseeable," *id.*, the threshold inquiry is whether the tax law in

issue represents merely a change or correction in the tax rate instead of a "wholly new tax."

In this case, Congress's retroactive restriction on the availability of 26 U.S.C. § 2057's deduction was "closer in kind and in effect to a mere increase in the tax rate than to the enactment of a wholly new tax" because the underlying estate tax has been in existence "long before" Congress created the short-lived deduction provided for in § 2057. *Fein*, 730 F.2d at 1213; *Estate of Ekins*, 797 F.2d at 484-85. Accordingly, because changes in tax laws are "by [their] very nature . . . reasonably foreseeable," retroactive application of the amendments to § 2057 does not violate due process.

While plaintiff's expectations are disrupted by the amendments' retroactivity, "retroactive legislation is not unconstitutional merely because it upsets settled expectations or because it effectively imposes a new liability on a past act." *Canisius College v. United States*, 799 F.2d 18, 26 (2d Cir. 1986). Moreover, the Supreme Court has expressed doubt that foreseeability of retroactive legislation is even a "relevant consideration" in Due Process Clause analysis. *See Pension Benefit Guaranty Corp. v. Gray & Co.*, 467 U.S. 717, 731-32, 81 L.Ed.2d 601, 612-13 (1984) (assuming arguendo that notice is a "relevant consideration"). Because "[l]egislative changes are to be expected, . . . the taxpayer assumes the risk that the tax burden on a particular transaction may increase pursuant to Congress's continual responsibility to carry out the necessary policies of taxation." *Estate of Ekins*, 797 F.2d at 483.

Moreover, at oral argument, plaintiff was not able to offer "any convincing beneficial alternatives available to [him] if [he] had been furnished advance notice of the change in the tax structure." *Id.* at 485.

Indeed, in response to a specific query from the Court, plaintiff indicated that no alternative means of escaping the federal estate tax existed. Hence, plaintiff was not precluded from obtaining another available deduction by his reliance on the terms of § 2057. Accordingly, plaintiff has failed to demonstrate that § 10411's restriction of § 2057's deduction, without notice, "gives a more oppressive legal effect to conduct undertaken before enactment of the statute." *United States v. Hemme*, 476 U.S. 558, 106 S.Ct. 2071, 2078, 90 L.Ed.2d 538 (1986).

Plaintiff's reliance on *Untermyer v. Anderson*, 276 U.S. 440, 72 L.Ed. 645 (1928); *Helvering v. Helmholz*, 296 U.S. 93, 80 L.Ed. 76 (1935); *Blodgett v. Holden*, 275 U.S. 142, 72 L.Ed. 206 (1927); and *Nichols v Coolidge*, 274 U.S. 531, 71 L.Ed. 1184 (1927) as dispositive of this case is misplaced. "*Untermyer* involved the levy of the *first* gift tax; its authority is of limited value in assessing the constitutionality of subsequent amendments that bring about certain changes in operation of the tax laws, rather than the creation of a wholly new tax." *Hemme*, 476 U.S. at 568, 106 S.Ct. 2071, 90 L.Ed.2d at 548.

Plaintiff's reliance on cases interpreting the Contract Clause, Art. I, sec. 10, cl. 1, is also misplaced. The Supreme Court has "never held" that federal legislation can be subjected to the strictures of the Contract Clause via "incorporation" of the clause into the Fifth Amendment's Due Process Clause. *Pension Benefit*, 467 U.S. at 733, 104 S.Ct. 2709, 81 L.Ed.2d at 613 ("principles embodied in the Fifth Amendment's Due Process Clause are not coextensive with prohibitions existing against state impairments of pre-existing contracts"). Furthermore, to the extent that plaintiff is challenging the subject tax on Contract Clause grounds, such challenge is ineffec-

tive. The Contract Clause does not impose any limitations on the actions of the federal government. *Id.* at n.9.

Plaintiff's argument that retroactive application of the amendments to § 2057 violates the Takings Clause of the Fifth Amendment is unpersuasive. There can be no violation of the Takings Clause on these facts because no "taking" has occurred. In this case, plaintiff made a *voluntary* sale of stock at a discounted price. Although plaintiff may have been induced to sell the stock to obtain the deduction under § 2057, the section does not appear to have required a discount sale to the ESOP as a condition to obtaining the estate tax reduction. Under § 2057's terms, a "qualified sale" included "*any sale*" of employer securities to an employee stock ownership plan (ESOP). Accordingly, plaintiff's voluntary execution of a below-market stock sale cannot be construed as a taking where the deduction's availability was not conditioned on a discounted sale price.

CONCLUSION

Accordingly, and for the foregoing reasons, the Court grants defendant's motion, construed as a motion for summary judgment, and hereby orders the action dismissed with prejudice.

IT IS SO ORDERED.

IT IS FURTHER ORDERED that the Clerk shall serve a copy of this Order on counsel for all parties.

Dated: April 15, 1991.

/s/ Alicemarie H. Stotler
ALICEMARIE H. STOTLER
United States District Judge

APPENDIX D

1. Section 2057 of the Internal Revenue Code of 1986, 26 U.S.C. 2057, as added by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1172(a), 100 Stat. 2513-2514, and prior to amendment by the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10411, 101 Stat. 1330-432 to 1330-433, provided in relevant part:

> ESTATE TAX DEDUCTION FOR PROCEEDS FROM SALES OF EMPLOYER SECURITIES.
>
> (a) *General Rule.*—For purposes of the tax imposed by Section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate an amount equal to 50 percent of the qualified proceeds of a qualified sale of employer securities.
>
> (b) *Qualified Sale.*—For purposes of this section, the term "qualified sale" means any sale of employer securities by the executor of an estate to—
>
> (1) an employee stock ownership plan * * * described in Section 4975(e)(7), or
>
> (2) an eligible worker-owned cooperative (within the meaning of Section 1042(c)).
>
> (c) *Qualified Proceeds.*—For purposes of this section—
>
> (1) *In general.*—The term "qualified proceeds" means the amount received by the estate from the sale of employer securities at any time before the date on which the

return of the tax imposed by Section 2001 is required to be filed (including any extensions).

(2) *Proceeds from certain securities not qualified.*—The term "qualified proceeds" shall not include the proceeds from the sale of any employer securities if such securities were received by the decedent—

(A) in a distribution from a plan exempt from tax under Section 501(a) which meets the requirements of Section 401(a), or

(B) as a transfer pursuant to an option or other right to acquire stock to which Section 83, 422, 422A, 423, or 424 applies.

* * * * *

2. Section 10411 of the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330-432 to 1330-433, provides as follows:

CONGRESSIONAL CLARIFICATION OF ESTATE TAX DEDUCTION FOR SALES OF EMPLOYER SECURITIES.

(a) *Intent of Congress in Enacting Section 2057 of the Internal Revenue Code of 1986.*—Section 2057 (relating to sales of employer securities to employee stock ownership plans or worker-owned cooperatives) is amended by redesignating subsections (d), (e), and (f) as subsections (e), (f), and (g), respectively, and by inserting after subsection (c) the following new subsection:

(d) *Qualified Proceeds From Qualified Sales.*—

(1) *In general.*—For purposes of this section, the proceeds of a sale of employer securities by an executor to an employee stock ownership plan or an eligible worker-owned cooperative shall not be treated as qualified proceeds from a qualified sale unless—

(A) the decedent directly owned the securities immediately before death, and

(B) after the sale, the employer securities—

(i) are allocated to participants, or

(ii) are held for future allocation in connection with—

(I) an exempt loan under the rules of Section 4975, or

(II) a transfer of assets under the rules of Section 4980(c)(3).

(2) *No substitution permitted.*—For purposes of paragraph (1)(B), except in the case of a bona fide business transaction (*e.g.*, a substitution of employer securities in connection with a merger of employers), employer securities shall not be treated as allocated or held for future allocation to the extent that such securities are allocated or held for future allocation in substitution of other employer securities that had been allocated or held for future allocation.

(b) *Effective Date.*—The amendments made by subsection (a) shall take effect as if included in the amendments made by subsection 1172 of the Tax Reform Act of 1986.

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(2)

No. 92-1941

In The
Supreme Court of the United States
October Term, 1993

UNITED STATES OF AMERICA,
Petitioner,
v.
JERRY W. CARLTON, EXECUTOR OF THE WILL OF WILLAMETTA K. DAY,
Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

RESPONDENT'S BRIEF IN OPPOSITION

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QUESTION PRESENTED

Can the government enact a new estate tax deduction to induce executors to sell estate assets at a discount to an employee stock ownership plan and, after a taxpayer has done so, retroactively impose additional, unforeseeable conditions and deny the deduction?

TABLE OF CONTENTS

[1] The appendix attached to the Solicitor General's petition contains four items, identified as Appendices A-D, and concludes with page 46a; to reduce the likelihood of confusion, the two documents appended to this brief are identified as Appendices E and F and begin with page 47a.

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TABLE OF AUTHORITIES – Continued

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RESPONDENT'S BRIEF IN OPPOSITION

STATEMENT OF THE CASE

In 1984, the Senate proposed an estate tax deduction for one-half of the proceeds of an executor's sale of an employer's stock to its employee stock ownership plan ("ESOP") completed before the deadline (including extensions) for filing a federal estate tax return. *See, e.g.*, Appendix, Petition for Writ of Certiorari, 21a; Appendix, *infra*, 49a (hereinafter "App., 21a" and "App., 49a," respectively); 2 Senate Comm. on Finance, 98th Cong., 2d Sess., *Statutory Language of Provisions Approved by the Committee on March 21, 1984*, 338-40 (S. Prt. 98-169). Although not enacted as a part of the 1984 tax legislation affecting

ESOPs, a similar provision was enacted effective October 22, 1986 and codified as Section 2057 of the Internal Revenue Code. Tax Reform Act of 1986, Pub. L. No. 99-514 ("TRA"), §§ 1172(a), (c), 100 Stat. 2085, 2513-15 (1986) (amended 1987; repealed 1989).[2] Between the time

[2] As enacted, the statute provided, in relevant part:

"SEC. 2057. SALES OF EMPLOYER SECURITIES TO EMPLOYEE STOCK OWNERSHIP PLANS. . . .

"(a) GENERAL RULE. – For purposes of *the tax* imposed by section 2001, the value of the taxable estate *shall be determined by deducting* from the value of the gross estate *an amount equal to 50 percent of the qualified proceeds of a qualified sale* of employer securities.

"(b) QUALIFIED SALE. – For purposes of this section, the term *'qualified sale' means any sale of employer securities by the executor of an estate to* –

"(1) *an employee stock ownership plan* is [sic] described in section 4975(e)(7). . . .

"(c) QUALIFIED PROCEEDS. – For purposes of this section –

"(1) IN GENERAL. – The term *'qualified proceeds' means the amount received* by the estate from the sale of employer securities at any time *before the date on which the [estate tax] return . . . is required to be filed (including any extensions).*

"(d) WRITTEN STATEMENT REQUIRED. –

"(1) IN GENERAL. – *No deduction shall be allowed* under subsection (a) *unless the executor* of the estate of the decedent *files* with the Secretary the statement described in paragraph (2).

"(2) STATEMENT. – A statement is described in this paragraph if it is *a verified written statement of* –

"(A) *the employer* whose employees are covered by the plan described in subsection (b)(1) . . .

"consenting to the application of section 4979A with respect to such employer or cooperative." (Emphasis added.)

Congress passed the TRA on September 25, 1986 and its adjournment on October 18, 1986, Congress considered a large number of potential technical and clerical corrections to the TRA and made several changes to it. No bill or resolution was introduced, however, that would have added any condition to the availability of the new estate tax deduction beyond those contained in the statute itself. (App., 3a-4a, 48a-49a.)

Respondent, Jerry W. Carlton as executor of the will of Willametta K. Day (the "executor" and "Mrs. Day" respectively), reviewed the provisions of the TRA, its amendments, and the possible amendments to it proposed before Congress adjourned and determined that it was in the estate's financial interest to avail itself of the new estate tax deduction (App., 50a). The executor purchased 1,500,000 shares of MCI Communications Corporation ("MCI") stock on December 10, 1986 for an average price of $7.47 per share and a total purchase price of $11,206,000 (App., 4a, 50a). Although the executor had determined that the trustee of MCI's ESOP might be interested in acquiring some MCI stock, the executor had no advance agreement to sell the stock to the ESOP and, thus, bore the risk of loss if the market for the stock were to decline or if the executor had to sell it back to a market-maker for less than the purchase price (App., 4a, 50a). On December 12, 1986 the trading price for MCI stock ranged from $7.125 to $7.50, and the executor entered into an agreement to sell the stock to the ESOP for $7.05 per share (26 cents per share below the mean trading price), for a total sale price of $10,575,000 (App., 4a-5a, 50a). In accordance with Section 2057, the executor obtained MCI's agreement to the application of 26 U.S.C.

§ 4979A (Supp. IV 1986) (amended 1989) to MCI (as required by Section 2057(d)) and obtained an opinion from its general counsel that its ESOP was a plan described in 26 U.S.C. § 4975(e)(7) (Supp. IV 1986) (amended 1990) (as required by Section 2057(b)(1)) (App., 51a; n.2, *supra*). On December 17, 1986, the sale was consummated (App., 51a).

The executor would *not* have purchased the stock at its then prevailing price of about \$7.47 per share and sold it to the ESOP at a discounted \$7.05 per-share price (and incurred incidental transaction costs) but for the new estate tax deduction; similarly, the ESOP would *not* have been able to purchase the stock at the discounted price if the executor had not expected to receive the estate tax deduction (App.~~, 5a,~~ 51a).

On December 29, 1986, the executor timely filed Mrs. Day's federal estate tax return, claiming a deduction for 50 percent of the proceeds of sale of the MCI stock and paying \$18,752,250 in estate tax (App., 5a, 51a).

In January 1987, the Internal Revenue Service ("Service") announced that "[p]ending the enactment of clarifying legislation," the Service would *not* recognize the deduction permitted under Section 2057 (1) unless a decedent "directly owned" the securities before death and (2) unless the securities were allocated or held for future allocation *by the plan* in particular ways[3] (App., 51a-52a;

[3] In general, the 1987 changes (a) require that the ESOP immediately allocate the securities to participants' accounts or hold them for future allocation in accordance with rules that apply in other contexts and (b) preclude the ESOP from substituting the securities or other employee stock already held by the ESOP.

Notice 87-13, 1987-1 C.B. 432, 442). Neither of those requirements was contained in the TRA, and neither was identified in the hundreds of technical and clerical amendments proposed before Congress adjourned (App., 5a, 52a). Moreover, there had been no prior notice from the Service that it would seek "clarifying legislation" (App., 17a).

In December 1987, Congress enacted legislation to impose these two additional requirements retroactively to the date that the statute was originally effective – as well as making a number of other changes effective for sales made after February 26, 1987, the date of introduction of the 1987 legislation (App., 5a-7a, 52a-53a; Omnibus Reconciliation Act of 1987, Pub. L. No. 100-203, § 10411, 101 Stat. 1330-432 to 1330-433).

When the Service audited Mrs. Day's federal estate tax return, it disallowed the claimed ESOP-proceeds deduction[4] and denied the executor's claim for refund after the executor paid the deficiency assessed (App., 53a-54a). Plaintiff then instituted this refund action in the district court. Although the district court held for the government (App., 42a), the Ninth Circuit reversed and remanded with instructions to enter judgment for the executor (with Judge Norris dissenting) (App., 25a). Thereafter, the Ninth Circuit denied the government's

[4] The Service asserted a deficiency of \$3,385,333 as a result of the audit. The net deficiency attributable to the ESOP-proceeds deduction was \$2,501,161. The executor does not dispute the remaining deficiency (App., 7a, 54a).

petition for rehearing and rejected its suggestion for rehearing en banc (App., 37a).

REASONS FOR DENYING THE WRIT

The writ should be denied, because (a) this case turns on the analysis of the particular facts involved, (b) there is no conflict between the Ninth Circuit's analysis and application of established constitutional principles in this case and the decisions of this Court and other decisions of the Court of Appeals, (c) the case was properly decided, and (d) the Ninth Circuit's narrowly-written decision involving a now-repealed statute will not hamstring the government in the administration of the revenue laws.

I. THE NINTH CIRCUIT DECISION TURNS ON THE ANALYSIS OF FACTS UNIQUE TO THIS CASE.

The disparity between the statement of the question presented in the Solicitor General's Petition for Writ of Certiorari ("Petition") and in this brief reveals the basic reason for denying the writ. In large measure, the Petition is a quarrel with the conclusion of law by the majority of the Ninth Circuit panel (the "majority") that the executor did not have constructive notice of the future imposition of the additional restrictions on the ESOP-proceeds deduction that the 1987 legislation purports to apply. The Solicitor General's arguments that retroactive application is consistent with this Court's traditional analysis under the Due Process Clause (Petition, 11-17) and that the majority announces "a new and unsupported method of

due process analysis" (Petition, 11, 17-23) are premised on his view that the executor had constructive notice of "curative" legislation to "close a loophole" and "avert potential abuse" (Petition, 14-20). Similarly, the egregious impact of the decision on the "routine enforcement of the federal revenue laws" and the "insurmountable obstacles" it will impose on "reasonable legislative action" that the Petition postulates (Petition, 11, 24) conceivably could follow only if one accepts the Solicitor General's version of the facts. If one accepts the facts stipulated in the trial court (App., 47a-54a) and the one determined by the majority as a matter of law (App., 17a-18a, 33a-35a), however, its decision is both unremarkable and correct.[5]

In this case, the government has stipulated that: (a) the decedent ownership requirement was not contained in Section 2057 as initially enacted (App., 5a, 52a); (b) it was not contained in any amendment to the statute passed by the Congress before the executor made his below-market sale to the ESOP and filed his estate tax return (App., 5a, 52a); (c) it was not contained in any of the hundreds of potential technical and clerical amendments to the statute considered before the Congress adjourned (App., 3a-5a, 48a-49a, 52a); and (d) "[n]o bill or

[5] Contrast the facts of this case with those in *Ferman v. United States*, 993 F.2d 485 (5th Cir., June 18, 1993) (a copy of which is attached to this brief as Appendix F), where most of the ALZA stock was purchased about six weeks *after* the advance release of the Notice and was subject to a prior agreement that the ESOP would, in turn, purchase the stock (App., 58a, 61a-62a, 70a-71a); here, the executor acted several weeks *before* advance issuance of the Notice and had no advance agreement with the ESOP (App., 4a, 50a).

resolution was introduced that would have added any condition to the availability of the new [s]ection 2057 deduction other than those contained in the statute itself during the period between the passage of the [1986 legislation] and the adjournment [of Congress] on October 18, 1986" (App., 4a, 49a).[6]

After a thorough review of the government's arguments, the majority concluded that "no act of the executive or legislative branch would have given any forewarning of the 1987 amendment at the time the MCI ESOP transaction occurred" (App., 17a-18a).

Assuming, *sub silentio*, that this Court may be disposed to review the majority's conclusion as part of the Court's review of the application of constitutional principles to the facts of the case at bar, the Solicitor General relies on four bases to advance the proposition that the executor did have constructive notice that the statute would be amended to include the restrictions that the Solicitor General seeks to apply retroactively. None of these is persuasive.

(a) The Solicitor General first asserts "that every taxpayer is deemed to have constructive notice of the possibility of changes in the provisions of existing tax

[6] In view of the multitude of proposed amendments to the TRA considered before adjournment of the 99th Congress (one of which dealt specifically with Section 2057) and the changes enacted to it by the Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, 100 Stat. 1874 (App., 3a-4a, 48a-49a), Congress did not act to amend the new section 2057 "at the first opportunity" as the Solicitor General now contends (Petition, 23).

laws" (Petition, 18). The majority aptly observed that this Court's carefully reasoned analysis in *United States v. Hemme*, 476 U.S. 558 (1986), and *United States v. Darusmont*, 449 U.S. 292 (1981) (*per curiam*), would have been unnecessary if there were a *per se* rule that tax statutes can *always* be retroactively applied so long as they do not enact a "wholly new" tax (App., 10a).

(b) The Solicitor General then contends that the history of the 1986 legislation should have forewarned the executor (Petition, n.13). He refers to a 1985 pamphlet reviewing legislative proposals concerning ESOPs published by the staff of the Joint Committee on Taxation and to a 1986 floor statement by Senator Long. As noted by the majority, "[b]oth of these references merely state that the ESOP-proceeds deduction would be *available* to a decedent who sold his company to an employee group. The government can point to no place in the legislative history that states that the ESOP-proceeds deduction would be *limited* to such a situation" (App., 18a). The majority also noted that omitting a decedent-ownership requirement from the ESOP-proceeds deduction could not be attributed to a "last-minute drafting error," because the deduction had been under consideration for over two and one-half years before it was enacted (App., 21a, 49a).

(c) The Solicitor General next contends that the deduction as originally enacted was "too good to be true" and that the executor should have anticipated a retroactive restriction or restrictions that would preclude his qualification for the deduction (Petition, 20, 23). As noted by the majority, this argument is unavailing for at least three reasons.

(1) The executor was justified in relying on the plain language of the statute, which contained no suggestion of the decedent ownership or allocation-by-the-ESOP-after-acquisition requirements. Just as this Court relies on the plain language and meaning of statutes in interpreting them, taxpayers are entitled to do the same. As the majority put it, "[w]e flatly reject the government's premise that a taxpayer cannot rely on the clear and unequivocal text of the Tax Code, but instead must speculate on the unspoken and inchoate intentions of Congress" (App., 19a-20a).

(2) Particularly when placed in the context of other uses of the tax law to encourage the funding of ESOPs, there is nothing particularly surprising about the absence of a decedent-ownership requirement. As explained by the majority,

> Congress has given several substantial tax incentives to ESOPs over the years. When a bank loans money to an ESOP to finance the purchase of shares, half of the interest income from such loans is excluded from taxable income. *See* 26 U.S.C. § 133. Taxpayers who sell shares to an ESOP may defer for tax purposes the recognition of any capital gain on such sale. *See* 26 U.S.C. § 1042. In this context, section 2057's provision allowing half of the proceeds of a sale of shares to an ESOP to be excluded from the taxable estate would not have appeared out of line.

(App., 21a.) Logically, there is no reason for a decedent-ownership requirement, because the goal of the Section 2057 deduction was to increase employee stock ownership at a bargain price (App., 19a); the ownership history

of the stock is irrelevant to the ESOP participants and the business enterprise that benefit from the ESOP stock ownership and from the bargain sale.[7]

(3) The executor's tax-induced sale was one with substantial economic substance and hardly a "sham transaction" as suggested by the Solicitor General's repeated quotation of then-Senator Bentsen's 1987 floor remarks (Petition, 5, 16, 17, 20).[8] The executor's sale at 5% below the mean trading price on December 12, 1986 (and significantly below the lowest price at which the MCI

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[7] The 1986 estate tax deduction was a part of the nation's long-standing policy of providing extraordinary encouragement for the growth of ESOPs through tax benefits. *See, e.g., 26 C.F.R. § 1.401-1(b)(1)(iii) (1956)* (subsequently amended). As summarized by the General Accounting Office late in 1986: "The major purposes of [ESOPs] are to broaden the ownership of stock, to provide a mechanism for financing capital growth and the transfer of stock ownership to employees, and to promote improvements in productivity and profitability in sponsoring firms. These goals are based on the belief that the concentration of stock ownership, the dependence of firms on internal sources of funds for corporate finance, and the slow growth of productivity in the U.S. are serious and related problems that can be addressed by making employees owners of stock in the firms that employ them." *Employee Stock Ownership Plans: Benefits and Costs of ESOP Tax Incentives for Broadening Stock Ownership* (GAO/PEMD '87-'88 December 1986). *See generally* Staff of the Joint Committee on Taxation, 99th Cong., 1st Sess., *Tax Reform Proposals: Tax Treatment of Employee Stock Ownership Plans (ESOPs)* 1-15 (Comm. Print 1985) (summarizing the history of the promotion of ESOPs through the revenue laws).

[8] Traditionally, the term "sham transaction" describes a transaction without economic substance: one disguised in form in an attempt to obtain favorable tax treatment. *See, e.g., Knetsch v. United States*, 364 U.S. 361 (1960).

stock was traded that day) (App., 50a) accomplished a transfer of wealth from the beneficiaries of Mrs. Day's estate to the ESOP participants – as the majority recognized (App., 23a-24a). The ESOP was able to save about $400,000 compared with the mean trading price, and the executor sacrificed a similar amount. Like other ESOP-promoting provisions of the revenue laws, Section 2057 did not require any particular discount; rather, it left that to bargaining in the marketplace. For example, the law does not require any specific discount in a bank's interest charges in a stock acquisition loan for a bank to exclude from its taxable income one-half of the interest received from an ESOP. *See* 26 U.S.C. § 133 (Supp. III 1991). Similarly, the law does not require any specific discount in a stockholder's sales price to an ESOP to defer recognition of all gain realized on the sale. *See* 26 U.S.C. § 1042 (Supp. III 1991). In each case, however, a discount from market price is essential to the ESOP's participation and for the executor or bank or shareholder to be able to enjoy the benefit of the applicable deduction or exclusion (App., 23a).[9] Indeed, the government has conceded that the executor would not have sold the stock at a discount below market price and the ESOP trustee would not have been able to purchase it at a discount but for the Section

[9] The Solicitor General's observation that "[w]hether the estate made a profit or loss on the sale is irrelevant to the deduction under Section 2057" (Petition, 4, n.6) misses the point. Although gain or loss when compared with income tax basis is irrelevant, sale below market price is the *sine qua non* of the deduction; without a discount, an ESOP simply will buy stock in the open market and the executor will get no deduction. A sale above income tax basis but below fair market value is just as much a bargain sale as one below income tax basis.

2057 deduction (App., 51a). As the majority noted, "Section 2057 worked" (App., 19a).

(d) Finally, the Solicitor General implicitly contends that the executor had constructive notice that the restrictions would be imposed because of the factors *later* discussed during the legislative considerations of the 1987 amendments to the Section 2057 deduction (Petition, 5-6, 16-17, 20). By repeating the 1987 floor statements of then-Senator Bentsen and Representative Rostenkowski about the projections of revenue loss and the intent of the prior Congress when they introduced the 1987 amendment with its purportedly retroactive application,[10] the Solicitor General implies that the purportedly unintended revenue loss, which "became clear soon after the passage of the 1986 act" (Petition, 5), should have been anticipated by the executor when he sold his MCI stock at a discount in early December 1986 and should have forewarned him of the change. This position would require prescience on the part of the executor that the government itself lacked; it was not until January 5, 1987 that the Service released the advance version of Notice 87-13 and until February 26, 1987 that the chairmen of the Congressional tax-writing committees introduced the legislation to restrict the

[10] This Court should exercise its traditional skepticism about the weight that should be accorded the views of members of a later Congress about the intent of a former one. *See, e.g., United States v. Vogel Fertilizer Co.*, 455 U.S. 16, 34 (1982) (citing *International Brotherhood of Teamsters v. United States*, 431 U.S. 324, 354, n.39 (1977)), particularly in view of the retirement of Senator Russell B. Long, who championed the cause of ESOPs as chairman (or ranking minority member) of the Senate Finance Committee from 1974 through the end of 1986.

availability of the Section 2057 deduction. The government has identified no basis for the premise that the executor could have known of a 1986 revenue-loss estimate or that he had the basis to make his own estimate. Moreover, as noted by the majority, even the revised revenue-loss estimate described by the legislators in February 1987 would have seemed plausible in the context of other spending for qualified plans (App., 20a-21a).

While review of fact-bound determinations such as the question of constructive notice in this case generally is not the purpose of certiorari, the foregoing demonstrates the substantial basis that undergirds the majority's decision. Thus, the legal question is the one set forth at the outset of this brief; it virtually answers itself. As demonstrated in the next section, the majority's analytic approach in applying traditional constitutional principles to the facts was consistent with established authority and not in conflict with the decisions of this Court or other decisions of the Court of Appeals.

II. THERE IS NO CONFLICT: THE NINTH CIRCUIT FOLLOWED TRADITIONAL DUE PROCESS ANALYSIS.

The majority identified and considered the traditional standards articulated by this Court in testing the retroactive application of the 1987 amendments to the Section 2057 deduction. It discussed both the "arbitrary and irrational"/"rational legislative purpose" formulation described in *Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1, 15 (1976), and *Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 733 (1984), upon which the

Solicitor General primarily relies in his Petition and the "nature of the tax and the circumstances in which it is laid"/"harsh and oppressive" formulation identified in *United States v. Hemme*, 476 U.S. 558, 568-69 (1986), *United States v. Darusmont*, 449 U.S. 292, 299 (1981) (*per curiam*), and *Welch v. Henry*, 305 U.S. 134, 147 (1938) (App., 9a). Moreover, the majority recognized the consistency in result of those two formulations. App., 9a-10a (citing *Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 733 (1984)).

The majority then reviewed the factual circumstances of several leading cases in which this Court has addressed a due process challenge to tax legislation (*Nichols v. Coolidge*, 274 U.S. 531 (1927); *Blodgett v. Holden*, 275 U.S. 142 (1927); *Untermyer v. Anderson*, 276 U.S. 440 (1928); *Welch v. Henry*, 305 U.S. 134 (1938); *United States v. Darusmont*, 449 U.S. 292 (1981) (*per curiam*); and, *United States v. Hemme*, 476 U.S. 558 (1986)) to determine the manner in which this Court has applied the formulations it has articulated – considering the "nature of the tax and the circumstances in which it is laid," as instructed by *Hemme* and *Welch* (App., 11a-17a). In addition, the majority reviewed two of the Ninth Circuit's own decisions (*Wheeler v. Commissioner*, 143 F.2d 162 (9th Cir. 1944), *rev'd on other grounds*, 324 U.S. 542 (1945), and *Licari v. Commissioner*, 946 F.2d 690 (9th Cir. 1991)) (App., 13a-14a, 16a-17a). As the dissent makes obvious, the Ninth Circuit panel also considered a substantial number of other decisions by this Court and various Circuits, although the

majority did not specifically discuss the facts and circumstances of each of them (App., 26a-33a).[11]

Having reviewed the tests prescribed by this Court and the ways in which they have been applied, the majority reviewed the unique facts and circumstances in which the present dispute arose, applied the tests to those unique facts, and concluded that the amendment to the estate tax deduction could not be applied consistently with the guarantee of the Due Process Clause (App., 17a-24a). In reaching that result, the majority emphasized several elements that distinguish the case at bar from the ones in which retroactive change was held to be permissible and that demonstrate the similarity to those in which retroactive change was not.

> (a) Despite the two years of congressional consideration (App., 21a, 49a), there was no hint in the legislative history of Section 2057 as enacted in 1986 that Congress intended to

[11] *Wiggins v. Commissioner*, 904 F.2d 311 (5th Cir. 1990); *Estate of Ekins v. Commissioner*, 797 F.2d 481 (7th Cir. 1986); *Fein v. United States*, 730 F.2d 1211 (8th Cir.), *cert. denied*, 469 U.S. 858 (1984); *Estate of Ceppi v. Commissioner*, 698 F.2d 17 (1st Cir.), *cert. denied*, 462 U.S. 1120 (1983); *Westwick v. Commissioner*, 636 F.2d 291 (10th Cir. 1980); *Purvis v. United States*, 501 F.2d 311 (9th Cir. 1974), *cert. denied*, 420 U.S. 947 (1975); *First National Bank in Dallas v. United States*, 420 F.2d 725 (Ct. Cl.), *cert. denied*, 398 U.S. 950 (1970); *Sidney v. Commissioner*, 273 F.2d 928 (2d Cir. 1960); *Miller v. Commissioner*, 115 F.2d 479 (9th Cir. 1940), *cert. denied*, 312 U.S. 703 (1941); *New England Baptist Hospital v. United States*, 807 F.2d 280 (1st Cir. 1986); *Canisius College v. United States*, 799 F.2d 18 (2d Cir. 1986), *cert. denied*, 481 U.S. 1014 (1987); and, *Temple University v. United States*, 769 F.2d 126 (3d Cir. 1985), *cert. denied*, 476 U.S. 1182 (1986).

> restrict the deduction only to executors of persons who had owned stock during lifetime and only in circumstances in which the trustee of the ESOP allocated the stock to participants or held that stock for future allocation to participants in a particular fashion after the ESOP acquired it. Similarly, there was no hint that Congress or the Administration was contemplating such restrictions when the executor sold his stock to the ESOP and filed his estate tax return in this matter (App., 17a-18a).
>
> (b) The executor was specifically induced to sell the MCI stock to its ESOP at below market value in order to share the estate tax benefits with the ESOP participants (App., 19a-20a).
>
> (c) Particularly when considered in the context of other ways in which the tax law has been used to encourage the funding of ESOPs, the executor had no reason to suspect that the 1986 statute did not mean exactly what it said (App., 20a-21a).
>
> (d) The executor suffered an actual loss, and not just a disappointed expectation, when he relied on the promise of an estate tax deduction in making the below-market sale to the ESOP (App., 19a, 21a-24a).

In summary, the majority engaged in the traditional due process analysis as articulated by this Court in *Hemme* and did not, as suggested by the Solicitor General in his Petition, adopt and apply "a novel and erroneous" one.

III. THE CASE WAS PROPERLY DECIDED: THE GOVERNMENT CANNOT RENEGE ON THE ESTATE TAX DEDUCTION AFTER IT HAS INDUCED THE EXECUTOR'S BELOW-MARKET SALE TO THE ESOP.

Retroactive application of the additional restrictions to the Section 2057 deduction to Mrs. Day's estate serves no legitimate legislative purpose and would produce a "harsh and oppressive" result in this circumstance. The Ninth Circuit decision is correct.

The Solicitor General suggests two purposes for application of the *post-hoc* requirements to this transaction:

> (a) "to fairly allocate to taxpayers the burdens and benefits of national fiscal policies" by providing a "uniform rule for all estates to which the tax deduction is available" (Petition, 14, 17); and
>
> (b) "to prevent evasion of [the revenue laws] 'by the vigilant and ingenious' " (Petition, 14, 16-17).[12]

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[12] Note that the Solicitor General does not argue as a matter of fact that retroactive application is necessary to protect the fisc, and there is no reason to believe that prospective application from the date of the Treasury's notice, the date of legislative introduction, or even the date of enactment would not produce roughly the same revenue result as retroactive application; similarly, the Solicitor General does not argue as a matter of law that raising revenue (by itself) provides a sufficient justification for retroactive application of laws depriving a citizen of the benefit of prior legislation that induced private conduct to pursue a public goal (whether that be funding an ESOP, building a canal or railroad, or buying and settling frontier land). Such a purported justification for the *post hoc* imposition of additional requirements would be no more compelling – or dispositive – today than it was in the 1920s and 1930s when this Court decided a series of estate and gift tax cases (*Nichols v. Coolidge*, 274 U.S. 531 (1927); *Blodgett v. Holden*, 275 U.S. 142 (1927); *Untermyer v. Anderson*, 276 U.S. 440 (1928); *Helvering v. Helmholz*, 296 U.S. 93 (1935); and, *White v. Poor*, 296 U.S. 98 (1935)) or over the prior Century when it decided a series of government-inducement cases. See discussion at pages 23-24, *infra*.

Neither withstands careful analysis, and each is premised on the Solicitor General's desired factual conclusion that the executor had constructive notice of the changes that the Solicitor General seeks to apply retroactively.

a. The Fair Allocation Purpose.

The Solicitor General's argument that application of the post-hoc restrictions to this case would produce a fair allocation ignores the facts of the case at bar. Neither Mrs. Day nor her executor enjoyed the economic benefit of prior conduct that gave rise to a particular cost, as was the case in *Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1 (1976) (benefit payments for coal miners with black lung disease). Similarly, neither Mrs. Day nor her executor enjoyed the benefit of some current government program benefiting only a few, as was the case in *United States v. Sperry Corp.*, 493 U.S. 52 (1989) (user fee for those pursuing claims against the Government of Iran through the United States Claims Tribunal). Apparently recognizing the absence of any special relationship between either

Mrs. Day or her executor and the government, the Solicitor General simply argues that retroactive application of what he characterizes as "curative legislation" would provide a uniform rule for those executors who sold before January 5, 1987 and those who sold after January 4, 1987 (Petition, 14, 17).[13] That would hardly produce a "fair" allocation of the revenue needs of the United States.

Those executors who sold stock to an ESOP after the advance release of the Service's announcement on January 5, 1987 enjoyed constructive notice (if not actual notice) that the Administration might seek to limit the deduction to situations in which the stock was "directly owned" by the decedent and in which the ESOP would allocate the stock among participants in a particular fashion.[14] Those executors who had acquired stock after a decedent's death could avoid making a constructive gift

[13] The Solicitor General's repeated characterization of the limitations on the ESOP-proceeds deduction that he seeks to impose retroactively as "curative legislation" assumes the adoption of his view that the executor had constructive notice because there was an obvious mistake in or omission from the statutory language. If, as the majority concluded, the executor could not have had constructive notice, then the legislation is not "curing" a "defect" or "closing a loophole." (This is not a case of omitting a "not" in hastily-drafted legislative language, as might be inferred from the Solicitor General's arguments (Petition, 24).)

[14] The Solicitor General's assertion that the Service announced that "it was seeking curative legislation" in Notice 87-13 (Petition, 4) overstates the case; rather, the Service announced an administrative position "pending the enactment of *clarifying* legislation." Notice 87-13, 1987-1 C.B. 432, 442 (emphasis added).

to the ESOP participants by declining to make below-market sales; all executors selling to an ESOP could obtain a commitment from a purchasing ESOP to allocate the stock as the Service wished. Mrs. Day's executor, who had already made a below-market sale, had no similar warning or opportunity to avoid his loss. Rather than producing a "fair" allocation, retroactive application in this case produces one that is manifestly unfair to the beneficiaries of Mrs. Day's estate. As the majority put it,

> [t]he federal government has long sought to promote employee ownership of shares in their employers. Section 2057 was enacted to induce taxpayers to sell shares at a discounted price to an ESOP, thus furthering the public policy of employee ownership. As intended, the Day estate succumbed to the lure and sold shares to the MCI ESOP at a substantial discount. Section 2057 worked. An ESOP was able to buy more shares at a lower price than before. Then, when the private actor had completed the socially desirable action of selling shares at a discount to an ESOP, the government reneged on its end of the deal. It was too late for Carlton to undo his sale to the MCI ESOP. The $631,000 was gone forever, irretrievable.

(App., 19a.) Like Mrs. Coolidge (in *Nichols v. Coolidge*, 274 U.S. 531 (1927)) and Mr. Blodgett (in *Blodgett v. Holden*, 275 U.S. 142 (1927)), who had no opportunity to rescind their *inter vivos* gifts that had preceded the estate and gift taxes, respectively, Mrs. Day's executor had no way to turn back the clock and choose a different course of

conduct after the Service's advance release of its notice.[15] If a "wholly new tax" cannot be imposed retroactively because doing so would be "harsh and oppressive," then *a fortiorari*, the government cannot allow a deduction if the tax benefit is shared with the ESOP and then renege after Mrs. Day's executor made the below-market sale and filed the estate tax return.[16]

Retroactive application would be arbitrary and irrational and would not serve any rational legislative purpose, because it will create an uncertainty that will discourage the people from accepting any new or unproven inducement to assist in the accomplishment of

[15] The facts of the instant case are substantially more compelling than those of *Coolidge* and *Blodgett*. There, gifts were made in the absence of a transfer tax; here the below-market sale was specifically induced by the ESOP-proceeds deduction.

[16] In his discussion of the *Coolidge* and *Blodgett* cases, the Solicitor General cites with approval an article by Professor Hochman (Petition, n. 11). He defines the appropriate test for retroactive tax legislation in his article as follows: "The primary consideration which appears from an analysis of the cases involving retroactive taxation is the ability of the taxpayer, at the time of the transaction dispute, reasonably to have foreseen that a tax would be imposed, and the likelihood that, having been able to foresee it, he would have altered his conduct to avoid the tax." Charles B. Hochman, *The Supreme Court and The Constitutionality of Retroactive Legislation*, 73 Harv. L. Rev. 692, 706 (1960) (footnote omitted). Here, the government has stipulated that the executor would *not* have made the bargain sale to the ESOP (and the ESOP participants would *not* have been enriched by the benefit of that bargain) but for the executor's expectation of a deduction under Section 2057 (App., 19a, 51a).

governmental objectives.[17] It is important to the implementation of governmental policy generally, as well as "a simple constitutional principle," that when it induces reliance, *"government must keep its word."* Laurence H. Tribe, *American Constitutional Law*, 619 (2d ed. 1988) (discussing limitations on state government action) (footnote omitted).[18]

The impermissibility of reneging on a promised benefit after inducing private conduct to pursue public goals has been a fundamental premise of this Court's jurisprudence since the earliest days of the Republic. Sometimes explained as a matter of "universal law," sometimes founded in the Contract Clause, and more recently based primarily on the Due Process Clauses of the Fifth and Fourteenth Amendments, this notion long predates the estate and gift tax cases of the earlier part of this century and is much broader than simply a prohibition against retroactive imposition of a "wholly new tax." *See Fletcher v. Peck*, 10 U.S. (6 Cranch) 87 (1810) (purchase of land-grant property); *New Jersey v. Wilson*, 11 U.S. (7 Cranch) 164 (1812) (property tax exemption for formerly Indian-owned lands); *Trustees of Dartmouth College v. Woodward*,

[17] How long should a prudent banker wait for possible legislative change before making a share acquisition loan to an ESOP at a below-market interest rate and thereby sharing with the ESOP participants and corporate sponsor the promised benefit of the bank's ability to exclude one-half of the interest from taxable income under 26 U.S.C. § 133?

[18] As discussed at pages 10-11 above and in the authorities cited in note 7, the government long has used the revenue laws to promote employee stock ownership generally and ESOPs in particular.

17 U.S. (4 Wheat.) 518 (1819) (*de facto* change to college charter); *The Binghamton Bridge*, 70 U.S. (3 Wall.) 51 (1866) (exclusive franchise); *Wilmington Railroad v. Reid*, 80 U.S. (13 Wall.) 264 (1871) (franchise tax exemption); *Humphrey v. Pegues*, 83 U.S. (16 Wall.) 244 (1872) (property tax exemption); *Pacific Railroad Co. v. Maguire*, 87 U.S. (20 Wall.) 36 (1873) (tax exemption); *Forbes Pioneer Boat Line v. Board of Commissioners*, 258 U.S. 338 (1922) (collection of canal tolls). Although the rationale – particularly with respect to the conduct of state governments – has evolved over time,[19] the underlying principle has remained constant.

The Solicitor General's fair allocation position in this case is a somewhat ironic one in light of the effective-date provisions of many of the other 1987 amendments to the ESOP-proceeds deduction. In addition to the decedent-ownership and allocation requirements involved in this case, the 1987 legislation imposed a number of additional constraints that dramatically narrowed the scope of the deduction for ESOP sales made after February 26, 1987 (the date of introduction of the legislation). *Omnibus Budget Reconciliation Act of 1987*, Pub. L. No. 100-203, § 10412, 101 Stat. 1330-433 to 1330-436. These included (1) a limit on the maximum deduction (the lesser of that deduction that would result in a $750,000 tax savings or a deduction equal to one-half of the taxable estate without the deduction), (2) a reduction of the sales proceeds that could

[19] *Cf.* Alexander M. Bickel & Benno C. Schmidt, Jr., *The Judiciary and Responsible Government 1910-21*, 300 (The Oliver Wendall Holmes Devise History of the Supreme Court of the United States Vol. IX, 1984).

qualify in the event the ESOP had purchased or sold employer securities in the prior year, (3) a disqualification of proceeds attributable to assets transferred to an ESOP from other forms of tax-exempt retirement plans (unless the Service determined otherwise), (4) a requirement that proceeds be received before the estate tax return was due, (5) a disqualification of stock a decedent acquired as compensation (whether tax-deferred or not) from the employer, (6) a limit to securities of an issuer that does not have any stock that is readily tradable on an established securities market, (7) a holding period requirement dating back to October 22, 1986 for the decedent or his or her spouse, and (8) a provision that disqualified stock if the decedent had engaged in some kinds of hedging transactions to reduce the risk of loss if the stock declined in value (App., 53a; *Omnibus Budget Reconciliation Act of 1987*, Pub. L. No. 100-203, § 10412; 101 Stat. 1330-433 to 1330-436). Executors who sold before the introduction of the legislation but who did not meet one or more of *these* restrictions still were eligible for the deduction. The only distinction between the two restrictions contained in the 1987 legislation that were supposed to be applied retroactively and the eight to be applied prospectively is that the two were presaged by the Service's administrative ruling position set forth in the January notice. Here, the executor acted several weeks *before* the Service's advance release of the notice on January 5, yet the government seeks to apply them to his situation. Doing so would treat similarly situated taxpayers (ones who acted before any hint of change) differently: the same notion of due process that supports a date-of-introduction distinction for the eight other restrictions enacted

by the 1987 legislation supports the result urged by the executor and reached by the Ninth Circuit in this case.

In summary, the Solicitor General's "fair allocation" purpose for retroactive application of the *post hoc* conditions to this transaction does not withstand scrutiny: there is no unusual government benefit now enjoyed by Mrs. Day's executor; neither she nor her executor has enjoyed any particular economic benefit as a result of prior conduct that has given rise to a particular cost borne by the government; and, to impose a constructive gift on Mrs. Day's beneficiaries by retroactive application would be manifestly unfair and would violate traditional constitutional principles embodied in the gift and estate tax cases decided under the Due Process Clause and as a consistent theme through our constitutional jurisprudence in other areas. Indeed, application to the case at bar where the executor acted several weeks before the Service's advance release of Notice 87-13 would be inconsistent with the general notion of due process inherent in the effective date provisions for the other 1987 changes affecting Section 2057. In short, retroactive application could lead to a "fair allocation" only if the executor had constructive notice.

b. The Tax Evasion Purpose

The Solicitor General's suggestion that the transaction at bar was an attempt by "the ingenious" to "evade" part of the burden of the estate tax also assumes the factual result that the Solicitor General pursues in this matter. As observed by the majority, "[i]t is undisputed that Carlton had no actual knowledge of the 1987 amendment imposing the decedent ownership requirement when he completed the MCI ESOP transaction" (App., 17a). The majority was correct that the executor did not have constructive notice of the change (first proposed by the Treasury on January 5) when the executor made his below-market sale on the prior December 12 (App., 17a-18a, 33a-35a) for the reasons set forth at pages 6 through 14 above. Absent constructive notice, the executor cannot have been engaged in "evasion," and this hypothesized purpose for retroactive application of the additional restrictions to the ESOP-proceeds deduction lacks a rational basis. The executor simply was doing what the new law encouraged him to do – share an expected tax savings with the ESOP.

IV. THE RESULT DOES NOT HAMSTRING THE GOVERNMENT.

The Ninth Circuit decision is narrowly written, emphasizing the unique factual circumstances in which this case arises, and imposes no impediment to the routine and necessary revision of the revenue laws of the United States.

As disclosed by the Solicitor General (Petition, n. 3), the Section 2057 deduction has been repealed in its entirety (Petition, n. 8; Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7304(a), 103 Stat. 2352-2353). The Ninth Circuit decision clearly relates only to this one transaction and to any other transaction that may have occurred between the President's signature of the 1986 legislation on October 22, 1986 and the Service's

advance release of its Notice 87-13 on January 5, 1987 (App., 24a) – a period of less than 2-1/2 months. Indeed, the majority suggests that it likely would reach a contrary result for any transaction that occurred after January 5, 1987 (App., 24a), and the Fifth Circuit recently has so concluded in the *Ferman* case (App., 56a).

The majority stresses the essential difference between the situation at bar and those in which this Court and the Ninth and other Circuits have rejected due-process challenges to retroactively-applied revenue laws in the past: the government encouraged Mrs. Day's executor to make a below-market sale to the ESOP with the estate tax deduction (App., 19a, 24a). Having induced this private conduct to pursue a public goal, the government now is constrained from applying the *post hoc* amendments to deprive the executor of the tax benefit. The cases cited by the Solicitor General to support retroactive application are clearly distinguishable, because none involves a situation like the case at bar (and, indeed, most involve situations in which the President had proposed or the Congress was actively considering legislative change at the time a taxpayer acted).

CONCLUSION

For the reasons set forth above, the Court should deny the petition for writ of certiorari.

Respectfully submitted,

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July 1993

APPENDIX E

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

SA CV 90-685 AHS (RWRx)

JERRY W. CARLTON, ETC., PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

STIPULATION AND ORDER
OF UNCONTROVERTED FACTS
AND NARROWING POTENTIAL ISSUES
IN CONTROVERSY

[Filed Mar. 27, 1991]

UNCONTROVERTED FACTS

1. Plaintiff, Jerry W. Carlton, is the executor of the will of Willametta K. Day ("Mrs. Day" and the "Estate," respectively) and an individual residing in Orange County, California.

2. Mrs. Day was a citizen of the United States of America who died on September 29, 1985; taking into consideration an extension of time to file, her estate tax return was due December 29, 1986.

3. The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986) (the "TRA"), was enacted on October 22, 1986. The TRA added new Section 2057 to the Internal Revenue Code ("Code"), which permitted fifty percent of

the qualified proceeds of a qualified sale of any employer securities to an Employee Stock Ownership Plan ("ESOP") to be deducted from the value of a decedent's gross estate. TRA § 1172(a), at 2513-14. * * * * The new deduction was made applicable to sales by executors required to file a return (including extensions) after enactment (and not just to persons dying after enactment). TRA § 1172(c), at 2515.

4. Between passage of the TRA by the Congress (as H.R. 3838) and Congress' adjournment several weeks later, a large number of potential technical and clerical corrections were identified and considered by the Congress as House Concurrent Resolution 395. As summarized in the "Blue Book" prepared by the Joint Committee on Taxation in the spring of 1987:

> On September 25, 1986, immediately after its approval of the conference report on H.R. 3838, the House passed (by voice vote) H. Con. Res. 395, to instruct the enrolling clerk to make certain technical and clerical corrections in the conference report statute.
>
> H. Con. Res. 395 was agreed to by the Senate (by voice vote) on October 16, 1986, with amendments. The House Rules Committee granted a rule on October 16, and the House adopted the rule (by voice vote) on October 17 for consideration of the resolution as amended by the Senate. Also on October 17, the House concurred in the Senate amendment with further amendments and returned the resolution to the Senate.
>
> On October 18, 1986, the Senate agreed (by voice vote) to certain of the House amendments to the resolution, disagreed to certain other amendments, and insisted on certain of its amendments. Also on October 18, the House disagreed to the Senate amendments to the House amendments to the original Senate amendment. H. Con. Res. 395 was not agreed to by both the House and the Senate before the 99th Congress adjourned *sine die* on October 18, 1986.

Joint Comm. on Tax., 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, at 4 (1987). During this consideration of several hundred potential technical and clerical amendments to the TRA, the Congress considered only one change to the new Section 2057 deduction – deletion of an extraneous "is" in Section 2057(b)(1). H.R. Con. Res. 395, 99th Cong., 2d Sess., 132 Cong. Rec. [32345, 32348, col. 1, reference to p. 453] (1986) [S16391, S16393 (daily ed. October 16, 1986)]. * * * *

5. Similarly, the Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, 100 Stat. 1874 (1986) – which was passed by the Congress after the TRA but signed by the President before the TRA – contained several changes to the TRA; none affected Section 2057.

6. No bill or resolution was introduced that would have added any condition to the availability of the new Section 2057 deduction other than those contained in the statute itself during the period between passage of the TRA and adjournment on October 18, 1986.

7. A legislative precursor of Section 2057 as enacted by the TRA was contained in the Senate version of the Deficit Reduction Act of 1984 (98th Cong., H.R. 4170). * * * *

8. In discharge of his duty as executor, plaintiff reviewed the provisions of the TRA and the amendments and possible amendments to it proposed before Congress adjourned and determined that it was in the Estate's financial interest to avail itself of the new Section 2057 deduction.

9. In an effort to reduce the estate tax payable as a result of Mrs. Day's death and to facilitate an ESOP's purchase of employer securities at a discounted price and in reliance on new Section 2057, plaintiff purchased 1,500,000 shares of MCI stock on December 10, 1986 for an average price of about $7.47 per share, or a total purchase price of $11,206,000, from Goldman, Sachs & Co., a broker who routinely makes a market in the over-the-counter stock. * * * *

10. Although plaintiff had determined that the trustee of MCI's ESOP might be interested in acquiring some MCI stock, plaintiff had no advance agreement to sell the stock to the trustee when plaintiff bought it and, thus, bore the risk of loss if the market for the stock declined or if plaintiff had to sell it back to a market maker for less than the purchase price.

11. On December 12, 1986, two days after purchasing the stock, plaintiff entered into an agreement to sell MCI stock to the trustee of MCI's ESOP for $7.05 per share, or a total sale price of $10,575,000. The National Association of Security Dealers, which reports daily on trading of MCI stock, reported that the price ranged from $7.125 to $7.50 per share on that day. * * * *

12. In accordance with Section 2057 as originally enacted, plaintiff obtained MCI's agreement to the application of 26 U.S.C. Section 4979A to it. * * * * Plaintiff also obtained an opinion from MCI's general counsel that its ESOP was a plan as identified in 26 U.S.C. Section 4975(e)(7).

13. On December 17, 1986, the sale was consummated.

14. Plaintiff would not have purchased the stock at its then-prevailing price of about $7.47 per share and sold the stock to the ESOP at a discounted $7.05 per share price (and incurred incidental transaction costs) if the executor had not anticipated a Section 2057 deduction. Similarly, the ESOP would not have been able to purchase the stock at the discounted price if the executor had not expected the Section 2057 deduction.

15. On December 29, 1986, plaintiff timely filed the United States Estate Tax Return, Form 706 (the "Return"), for the Estate. Pursuant to Section 2057 as it existed at that time, plaintiff deducted $5,287,500, fifty percent of the proceeds received from the ESOP on the sale of the MCI stock, from the value of Mrs. Day's gross estate. Overall, plaintiff reported and paid a net estate tax of $18,752,250.

16. On January 5, 1987 and on January 26, 1987, respectively, the Service issued an advance version of and then formally published Notice 87-13 (the "Notice") addressing a number of miscellaneous statutory changes affecting employee plans. I.R.S. Notice 87-13, 1987-1 C.B. 432. Question and Answer 23 of the Notice indicated that "[p]ending the enactment of clarifying legislation," the

Service would *not* recognize the deduction permitted under Section 2057 (1) unless a decedent "directly owned" the securities before death and (2) unless the securities were allocated or held for future allocation by the plan in particular ways. *Id.* at 442. * * * *

17. Neither of the requirements announced in the Notice was contained in the statute as originally enacted, neither was identified in the proposed technical and clerical amendments discussed before Congress adjourned, and neither was added to the statute (although other changes to the TRA were made) before Congress adjourned.

18. On February 26, 1987, what became Section 10411 of the Omnibus Budget Reconciliation Act of 1987 ("OBRA") was introduced in Congress. Section 10411 of OBRA proposed to amend Section 2057 to impose the additional requirements identified in the Notice – effective retroactively. * * * *

* * * *

20. On December 22, 1987, Section 10411 of OBRA was enacted, amending Section 2057 to require that a decedent "directly own" securities immediately before death and that the ESOP comply with the Notice's additional allocation rules in order for a selling estate to qualify for the deduction. Pub. L. No. 100-203, § 10411(a), 101 Stat. 1330-432 (1987). The heading of OBRA § 10411 is titled "CONGRESSIONAL CLARIFICATION OF ESTATE TAX DEDUCTION FOR SALES OF EMPLOYER SECURITIES." Paragraph (a) of the section is titled "INTENT OF CONGRESS IN ENACTING SECTION 2057 OF THE INTERNAL REVENUE CODE OF 1986." * * * *

21. In addition to the purportedly retroactive changes to Section 2057, OBRA added a number of other constraints to Section 2057 to be applied only to sales made after February 26, 1987 (the date of introduction). These included a limit on the maximum deduction (the lesser of that deduction that will result in a $750,000 tax savings or a deduction equal to one-half of the taxable estate without the deduction), a reduction of the sales proceeds that could qualify in the event the ESOP had purchased or sold employer securities in the prior year, a disqualification of proceeds attributable to assets transferred to an ESOP from other forms of tax-exempt retirement plans unless the Service determined otherwise, a requirement that proceeds be received before the estate tax return is due, a disqualification of stock a decedent acquired as compensation (whether tax-deferred or not) from the employer, a limit to stock that is not readily tradable on an established securities market, a holding period requirement dating back to October 22, 1986 for the decedent or his spouse, and a provision that disqualified stock if the decedent had engaged in some kinds of hedging transactions to reduce the risk of loss if the stock declined in value.

22. Section 2057 was repealed * * * * by Section 7304(a) of the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7304(a), 103 Stat. 2106, 2352-54 (1989).

23. The federal estate tax return for Mrs. Day's estate was subsequently audited, and the Internal Revenue Service issued a Report of Estate Tax Examination changes to the Executor on March 13, 1989 with adjustments which resulted in an estate tax deficiency of

$3,385,333.00. The net deficiency attributable to the § 2057 adjustment was $2,501,161.00. Plaintiff does not dispute the other adjustments.

24. On March 30, 1989, plaintiff paid the total deficiency of $3,385,333.00, plus $996,953.18 interest. On July 3, 1989, plaintiff filed a claim for refund of $2,501,161.00 * * * * , which was denied on August 1, 1989. * * * * The Executor subsequently filed the complaint upon which this case is based, on October 11, 1990, seeking a refund of $2,501,161.00, plus interest and costs, including attorneys' fees.

NARROWING POTENTIAL ISSUES IN CONTROVERSY

25. If the provisions of Pub. L. No. 100-203, § 10411(a), 101 Stat. 1330-432 (1987) amending Section 2057 of the Internal Revenue Code of 1986 cannot constitutionally be applied to eliminate the deduction claimed pursuant to that section on Mrs. Day's federal estate tax return as it was filed, then the taxpayer is entitled to judgment as sought in the complaint. (The United States does not contest the taxpayer's entitlement to the deduction as the statute existed when the estate tax return was filed or oppose the refund on any basis other than the 1987 amendment to Section 2057.)

26. If, on the other hand, that amendment can be applied to eliminate the deduction claimed by the executor, then the Government is entitled to judgment in these proceedings. (The taxpayer does not assert any basis for a

refund other than that the amendment to Section 2057 cannot constitutionally be applied in this situation.)

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ORDER

IT IS SO ORDERED.

Dated: March 27, 1991

/s/ Alicemarie H. Stotler
ALICEMARIE H. STOTLER
United States District Judge

APPENDIX F

**Bertha Paglin FERMAN, etc.,
Plaintiff-Appellant,**

v.

**UNITED STATES of America,
Defendant-Appellee.**

No. 92-3482.

United States Court of Appeals,
Fifth Circuit.

June 18, 1993.

Taxpayer brought suit to obtain refund of federal estate taxes. The United States District Court for the Eastern District of Louisiana, George Arceneaux, Jr., J., 790 F.Supp. 656, granted summary judgment in favor of government, and taxpayer appealed. The Court of Appeals, King, Circuit Judge, held that amendment to Internal Revenue Code, which retroactively restricted availability of state tax deduction for sale of employer securities to employee stock ownership plan, did not violate due process.

Affirmed.

Appeals from the United States District Court for the Eastern District of Louisiana.

Before KING and EMILIO M. GARZA, Circuit Judges, and HALL,* District Judge.

KING, Circuit Judge:

Bertha Paglin Ferman, acting in her capacity as executrix of the estate of Jules J. Paglin, brought this action against the United States to obtain a refund of $117,362.03 in federal estate taxes, plus interest and costs. Ferman asserts that an amendment to the Internal Revenue Code, which retroactively restricted the availability of an estate tax deduction for the sale of employer securities to an employee stock ownership plan, violates due process as applied to Paglin's estate. The parties filed cross-motions for summary judgment before the district court, which granted summary judgment in favor of the government. Ferman appeals from that judgment. Finding that, in the context of the facts before us, the retroactive amendment to the deduction at issue does not constitute a violation of due process, we affirm the district court's grant of summary judgment in favor of the government.

I. BACKGROUND

The facts in the case before us are not in dispute, and they have been presented by the court below. *See Ferman v. United States,* 790 F.Supp. 656 (E.D.La.1992). Following is a brief discussion of (a) section 2057 of Title 26 and its amendment, (b) the facts relevant to this appeal, and (c) the proceedings below.

A. *Section 2057*

The Tax Reform Act of 1986, Pub.L. No. 99-514, 100 Stat. 2085 (the Act), was enacted on October 22, 1986. Section 1172(a) of the Act added section 2057 to the

Internal Revenue Code, which allowed estates a deduction for fifty percent of the "qualified proceeds" of a "qualified sale" of any employer securities to an employee stock ownership plan (ESOP). *See* 26 U.S.C. § 2057. The term "qualified sale" was defined as "any sale of employer securities by the executor of an estate to . . . an employee stock ownership plan . . . described in section 4975(e)(7)." 26 U.S.C. § 2057(b)(1). "Qualified proceeds" was defined as "the amount received by the estate from the sale of employer securities at any time before the date on which the return of the tax imposed by section 2001 is required to be filed." 26 U.S.C. § 2057(c)(1). Under section 1172(c) of the Act, section 2057 was made applicable to sales by executors required to file estate tax returns after the date of its enactment. As discussed below, section 2057 made it possible for the executor of an estate to purchase stock from a company and then resell that stock to the company's ESOP – usually at a discount so as to provide an incentive for the ESOP to participate in the transaction – in order to receive a fifty percent deduction on the proceeds of that sale.

On January 5, 1987, the Internal Revenue Service (IRS) issued a news release addressing a number of statutory changes affecting employee plans. This notice was formally published on January 25, 1987 as Notice 87-13, 1987-1 C.B. 432 (Notice 87-13). "Question-and-answer 23" of Notice 87-13 indicated that, "[p]ending the enactment of clarifying legislation," the IRS would not recognize the deduction permitted under section 2057 unless (1) the decedent directly owned securities *before death* and (2) the

securities were allocated or held for future allocation by the plan in specified ways. *Id.* at 442.

On February 26, 1987, proposed legislation concerning the scope of section 2057's deduction was introduced into Congress. The bill's sponsors stated that it "would confirm the positions taken in IRS Notice 87-13" and that, "[b]ecause these provisions accurately reflect Congressional intent in enacting the provision, this clarification would be effective as if included in the [1986 Act]." 133 Cong. Rec. H845 (daily ed. Feb. 27, 1987); 133 Cong.Rec. S2532 (daily ed. Feb. 27, 1987). This proposal made its way into the Omnibus Reconciliation Act of 1987, Pub.L. No. 100-185, 101 Stat. 1330 (the 1987 Act), which was enacted into law on December 22, 1987. Section 10411 of this Act amended section 2057 of the Internal Revenue Code to impose the additional requirements identified in Notice 87-13, effective as if the provision had been contained in the 1986 Act.[1] The legislative history behind the enactment of the 1987 Act states, in pertinent part,

> [i]n enacting the estate tax deduction[,] Congress intended that it would be utilized in a limited number of transactions with a relatively modest revenue loss. As drafted, the estate tax deduction was significantly broader than what was originally contemplated by Congress in enacting the provision. The committee believes it is necessary to conform the statute to the

[1] Although not important for the purposes of resolving the case before us, we note that section 2057 was subsequently repealed for the estates of persons dying after July 12, 1989. *See* Omnibus Budget Reconciliation Act of 1989. Pub.L. No. 101-239, 103 Stat. 2106, 2352-2354, § 7304(a).

original intent of Congress in order to prevent a significant revenue loss under the Tax Reform Act of 1986.

While Congress intended to encourage transfers of employer securities to ESOPs by providing for partial elimination of estate tax liability, it was not intended that estates be able to eliminate all estate tax liability through use of the deduction[,] or that the securities acquired in a transaction for which the deduction was claimed need not be allocated to plan participants. The provision would not have been adopted in its present form had the full extent of the revenue impact and the effect of the provision been recognized.

The committee concludes that it is now necessary to modify the provision to bring the revenue loss in line with the original estimate and congressional intent. The modifications contained in the bill are designed to achieve this result while maintaining to the fullest extent possible the incentive to transfer employer securities to ESOPs.

The primary thrust of the bill is to conform the provision to the original intent of Congress in enacting the deduction. In this respect, the bill has two elements.

First, the bill makes clear that the positions taken by the Internal Revenue Service in Notice 87-13 with respect to the estate tax deduction are an accurate statement of Congressional intent in enacting the provision. If these clarifications are not made, taxpayers could qualify for the deduction by engaging in essentially sham transactions.

Second, the bill makes additional changes in the deduction which more fully effectuate the intent of Congress to provide limited relief for the estate tax.

H.R.Rep. No. 100-391(II), 100th Cong., 1st Sess. 1045 (1987), *codified at* 4 U.S.C.C.A.N. 2313-1, 2313-661 (1987); *see also* H.R.Conf. Rep. No. 100-495, 100th Cong., 1st Sess. at 998 (1987), *codified at* 4 U.S.C.C.A.N. 2313-1245, 2313-1744 (1987) (adopting the House version of the bill).

B. *The Paglin Estate's Reliance on the Unamended Version of Section 2057*

Bertha Paglin Ferman is the testamentary executrix of the estate of her father, Jules J. Paglin (decedent). At the time of his death on October 27, 1986, the decedent owned stock in over 75 publicly traded corporations, including 100 shares of ALZA Corporation stock valued at $2,031.25; the decedent had no legal relationship with the ALZA ESOP at the time of his death.

From February 20 to February 24, 1987, decedent's estate entered into three series of transactions in which it purchased shares of ALZA Corporation stock, and then sold those shares to the ALZA Corporation ESOP: (1) on February 20, the estate purchased 12,300 shares of stock at a total cost of $348,960, which it sold to the ESOP that same day for $329,175; (2) on February 23, the estate purchased 112,200 [sic] shares of ALZA stock for $329,090, which it sold to the ESOP that same day for $310,317.50; and (3) on February 24, the estate purchased 11,200 shares of ALZA Corporation common stock for

$310,100, which it sold to the ESOP that day for $292,600.[2] The parties have stipulated that the $7,000 brokerage commission paid by the estate when originally purchasing the stock and the stock value discounts given to the ESOP resulted in a total loss to the estate of $49,057.50.[3]

Ferman entered these transactions on the advice of her attorneys in order to realize a tax deduction under section 2057, and the parties have stipulated that her "decision to purchase these shares of ALZA stock, pay the commissions due on the purchases, and resell the stock to the ALZA ESOP at a discount, was purely tax motivated." The parties have also stipulated that

> [t]he only reason that the estate purchased ALZA stock, as opposed to the stock of another company, was the fact that the ALZA ESOP had by prior agreement agreed to purchase at a discount the entire quantity of ALZA Corporation stock directly from the estate, and the ALZA ESOP agreed to make the purchase from the estate over the three-day period.

Ferman also chose the ALZA ESOP because it agreed to purchase the shares at a lower discount than the other ESOPs she contacted.

On December 15, 1987, the estate filed a claim with the IRS for a refund on its federal estate taxes in the amount of $177,362.03, plus interest. According to the

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[2] These stock purchase prices include brokerage commissions paid by the estate and, therefore, they do not reflect the actual market value of the stock.

[3] The record does not disclose whether the estate in any way claimed this loss as a tax deduction.

estate, it was entitled to a deduction under section 2057 in the amount of $466,046.25, or one-half of the $932,092.50 total proceeds received from its sales of ALZA Corporation stock to the ALZA ESOP. This deduction reduced the decedent's taxable estate from $1,869,839.03 to $1,403,792.78, and the estate's tax liability from $511,097.55 to $333,735.52, for a total savings of $177,362.03. The IRS denied the estate's refund claim on January 31, 1990.

C. *Proceedings*

Soon after the IRS denied the estate's refund, Ferman instituted this action contending that (1) the estate is entitled to the ESOP sales deduction because it fully complied with the plain meaning of section 2057 as it existed at the time the sales were consummated, and (2) retroactive application of the 1987 Act to the estate's circumstances violates the Due Process Clause of the Fifth Amendment. Ferman moved for summary judgment, and the IRS filed a cross-motion for summary judgment, contending that the government's retroactive amendment to section 2057 does not constitute a violation of due process.

The district court granted summary judgment in favor of the IRS, holding that the government's retroactive amendment to section 2057 does not violate the Due Process Clause. First, the court rejected Ferman's argument that "she could not have foreseen Congress' retroactive amendment of section 2057 because no legislative action took place until after she completed the stock transfers at issue." *Ferman*, 790 F.Supp. at 661. According

to the district court, "Notice 87-13 forewarned what the future could and ultimately did bring." *Id.* The court also stated that "[i]t would seem abundantly clear that, given the IRS' position, Congress would enact corrective and retroactive legislation at the earliest possible time." *Id.* The district court also noted that, "[w]hile the net effect of the 1987 amendments to section 2057 clearly denied the Paglin estate the benefits of the fifty percent deduction, such denial did not amount to a 'new tax' as contemplated by the relevant law." *Id.*

Finally, the district court dismissed the estate's reliance upon such cases as *Untermyer v. Anderson*, 276 U.S. 440, 48 S.Ct. 353, 72 L.Ed. 645 (1928), and *Blodgett v. Holden*, 275 U.S. 142, 48 S.Ct. 105, 72 L.Ed. 206, *modified*, 276 U.S. 594, 48 S.Ct. 105, 72 L.Ed. 206 (1928), where the Supreme Court refused to subject gifts to the gift tax where they were completed before the first gift tax had even been implemented. The district court recognized that, in *United States v. Hemme*, 476 U.S. 558, 106 S.Ct. 2071, 90 L.Ed.2d 538 (1986), the Supreme Court limited *Untermyer* to its facts, specifically stating that *Untermyer* is of questionable value in assessing the constitutionality of amendments that bring about changes in the operation of *existing* tax laws. Accordingly, the district court distinguished *Untermyer* and *Blodgett* from the case before us on the grounds that this case "does not involve a new estate tax on intervivos gifts but, rather, a change in the application of an estate tax deduction." *Id.* at 662. In sum, although the district court stated that, "[i]n all candor, the court, in this instance, sincerely hopes that, should its judgment be appealed, the court (or courts) above will find error in this ruling[,]" it concluded that "it is true beyond peradventure that Congress may surely correct any error or inadvertence it may have created; indeed, Congress is constitutionally able to change and modify our nation's tax laws at will." *Id.* at 662-63.

II. ANALYSIS

The parties have stipulated that (1) the government erred in drafting section 2057 in that it failed to properly estimate the cost to the United States Treasury resulting from the deduction created under this section, (2) the government's statutory power to tax generally includes the discretion to correct such mistakes, and, (3) solely as a result of this deduction, Ferman entered into transactions which, although they benefited the estate under the unamended version of section 2057, were otherwise to the detriment of the estate in the amount of $49,057.50.[4] On appeal, Ferman contends that she reasonably relied upon section 2057 when entering into the transactions at issue between February 20 and February 24, 1987. The government contends that (1) it acted within its taxing authority in applying its 1987 amendment to section 2057 retroactively, for this amendment constitutes an adjustment to an existing tax rather than a new tax, and (2) Ferman's reliance on section 2057 was not reasonable in light of (a) Notice 87-113, (b) the legislative history behind section 2057, and (c) the extent of the government's error in drafting section 2057. Accordingly, the issue before us

[4] This amount constitutes the aggregate of (1) the broker's commissions paid by the estate when it purchased the ALZA stock and (2) the discounts given to the ALZA ESOP on the price of the stock.

constitutes a question of law: We must determine whether, in the context of the facts before us, the government's retroactive application of its amendment to section 2057 constitutes a violation of due process or a legitimate exercise of the government's statutory power to tax.

The Supreme Court has held that the retroactive application of a tax statute violates the Due Process Clause where the result is "so harsh and oppressive as to transgress the constitutional limitation." *Hemme,* 476 U.S. at 568-69, 106 S.Ct. at 2078, *quoting Welch v. Henry,* 305 U.S. 134, 147, 59 S.Ct. 121, 125, 83 L.Ed. 87 (1938).[5] In making such a determination, courts must "consider the nature of the tax and the circumstances in which it is laid. . . . " *Hemme,* 476 U.S. at 568-69, 106 S.Ct. at 2078.

In *Welch,* the case in which the Court introduced this "harsh and oppressive" impact standard, a Wisconsin taxpayer challenged the state's imposition of additional taxes arising from a change in the tax rate on corporate dividends received by the taxpayer one and two years

[5] Outside of the tax context, the Court has held that the retroactive application of a statute must be "arbitrary and irrational" to violate due process. *See Usery v. Turner Elkhorn Mining Co.,* 428 U.S. 1, 15, 96 S.Ct. 2882, 2892, 49 L.Ed.2d 752 (1976). Nevertheless, this difference is actually just one of semantics, for the Court has held that the "harsh and oppressive" impact standard used in the tax context "does not differ from the prohibition against arbitrary and irrational legislation that we clearly enunciated in *Turner Elkhorn.*" *Pension Benefit Guaranty Corp. v. R.A. Gray & Co.,* 467 U.S. 717, 733, 104 S.Ct. 2709, 2720, 81 L.Ed.2d 601 (1984).

earlier. Although it had previously struck down retroactive taxes on gifts,[6] the Court upheld the Wisconsin statute by distinguishing the tax at issue from gift taxes. Specifically, the Court held that

> a tax on the receipt of income is not comparable to a gift tax. We cannot assume that stockholders would refuse to receive corporate dividends even if they knew that their receipt would later be subjected to a new tax or to the increase of an old one. . . .

305 U.S. at 148, 59 S.Ct. at 126. The Court then went on to place the right to tax income retroactively within the realm of the broad taxing power of legislatures, stating that

> [w]e cannot say that the due process which the Constitution exacts denies that opportunity to legislatures; that it withholds from them, more than in the case of a prospective tax, authority to distribute the increased tax burden in the light of experience and in conformity with accepted notions of the requirements of equal protection; or that in view of well established legislative practice, both state and national, taxpayers can justly assert surprise or complain of arbitrary action in the retroactive apportionment of tax burdens to income at the first opportunity after knowledge of the nature and amount of the income is available.

Id. at 149-150, 59 S.Ct. at 127.

[6] *See Untermyer,* 276 U.S. at 440, 48 S.Ct. at 353; *Blodgett,* 275 U.S. at 142, 48 S.Ct. at 105; *Nichols v. Coolidge,* 274 U.S. 531, 47 S.Ct. 710, 71 L.Ed. 1184 (1927).

In cases decided subsequently to *Welch* and the *Nichols-Blodgett-Untermyer* triology, the Court has drawn a clearer distinction between the retroactive imposition of a wholly new tax and a retroactive change in the base or rate of an existing tax. *See, e.g., Hemme,* 476 U.S. at 568, 106 S.Ct. at 2077; *United States v. Darusmont,* 449 U.S. 292, 299, 101 S.Ct. 549, 553, 66 L.Ed.2d 513 (1981).[7] In *Darusmont,* the Court considered a challenge to the retroactive application of a minimum tax provision which increased the tax due from the sale of a taxpayers' home which had occurred before the provision was enacted. After stating that "[t]he proposed increase in rate had been under

[7] This court and our sister circuits also have recognized the distinction between a retroactive change in existing tax law and the retroactive imposition of a wholly new tax, thereby limiting *Nichols, Blodgett,* and *Untermyer* to their facts. *See, e.g., Wiggins v. Commissioner,* 904 F.2d 311, 314 (5th Cir.1990) (upholding retroactive exclusion of investment tax credit recapture when calculating an alternative minimum tax); *Estate of Ekins v. Commissioner,* 797 F.2d 481, 484 (7th Cir.1986) (upholding the retroactive repeal of an estate tax exclusion for life insurance policies); *Fein v. United States,* 730 F.2d 1211, 1213 (8th Cir.), *cert. denied,* 469 U.S. 858, 105 S.Ct. 188, 83 L.Ed.2d 121 (1984) (same); *Estate of Ceppi v. Commissioner,* 698 F.2d 17, 21 (1st Cir.1983), *cert. denied,* 462 U.S. 1120, 103 S.Ct. 3088, 77 L.Ed.2d 1350 (1983) (upholding the retroactive repeal of an estate tax exclusion); *Westwick v. Commissioner,* 636 F.2d 291, 292 (10th Cir.1980) (retroactive changes in the minimum tax upheld in spite of detrimental reliance); *First National Bank in Dallas v. United States,* 420 F.2d 725, 730 n. 8, 190 Ct.Cl. 400 (1970) (interest equalization tax on foreign stock acquisitions may be retroactively applied), *cert. denied,* 398 U.S. 950, 90 S.Ct. 1868, 26 L.Ed.2d 289 (1970); *Sidney v. Commissioner,* 273 F.2d 928, 932 (2d Cir. 1960) (upholding retroactive taxation of gains realized from collapsible corporations).

public discussion for almost a year before its enactment" and that taxpayers were therefore in no position to claim surprise, the Court held that taxpayers' " 'new tax' argument is answered completely by the fact that the 1976 amendments to the minimum tax did not create a new tax." 449 U.S. at 299-300, 101 S.Ct. at 553. Similarly, in *Hemme,* the trustee of a taxpayer's estate challenged the retroactive application of a transitional rule bridging the gap between new and old regimes for federal taxation of gifts and estates. Applying the "harsh and oppressive" impact standard introduced in *Welch,* the Court "considered the nature of the tax and the circumstances in which it [was] laid. . . . " 476 U.S. at 568-69, 106 S.Ct. at 2078. The Court, without determining whether the provision at issue constituted retroactive taxation, held that "the provision represents a fair judgment by Congress that does not deprive appellees of anything to which they can assert a constitutional right." *Id.* at 571, 106 S.Ct. at 2079.

The change in tax law at issue in the case before us – the retroactive amendment to (and limitation of) a deduction created under the Tax Act of 1986 – cannot be characterized as a retroactive imposition of a wholly new tax. The estate tax was in place before section 2057 was introduced, and the amendment at issue simply limited the deduction provided under 2057, thereby restoring the pre-section 2057 status quo. To determine whether the retroactive amendment of section 2057 constitutes a change in tax law "so harsh and oppressive as to transgress the constitutional limitation[,]"[8] we must carefully

[8] *Hemme,* 476 U.S. at 568-69, 106 S.Ct. at 2078, *quoting Welch,* 305 U.S. at 147, 59 S.Ct. at 125.

consider the nature of the tax and the facts before us. *Hemme*, 476 U.S. at 568-69, 106 S.Ct. at 2078; *cf. Wiggins*, 904 F.2d at 316 (when retroactive legislation is challenged on due process grounds, a case-by-case analysis is required).[9]

Evaluating the government's retroactive amendment of section 2057 in the context of the facts before us, we conclude that the government did not inflict a "harsh and oppressive" change in tax law upon Paglin's estate. First, Notice 87-13 was formally published on January 25, 1987 – nearly a month *before* Ferman entered into the series of transactions at issue in this case. This fact distinguishes the case before us from the Ninth Circuit's opinion in *Carlton v. United States*, 972 F.2d 1051 (9th Cir.1992). Specifically, although *Carlton* also involved an executor's reliance on section 2057, the executor in that case entered the transaction at issue nearly one month *before* the IRS issued Notice 87-13. In reaching its conclusion that, as applied to Carlton's transaction, Congress' amendment to section 2057 violated the Due Process Clause, the Ninth Circuit was careful to distinguish the district court opinion in the instant case and to clarify that its "conclusion would likely be entirely different if Carlton had engaged in his transaction after January 5, 1987." *Id.* at 1062, *citing Ferman*, 790 F.Supp. at 656.

[9] In *Wiggins*, this court held that a retroactive amendment establishing an investment tax credit recapture constituted a correction rather than a new tax. 904 F.2d at 314. Specifically, we stated that "[t]he legislative history of the 1984 amendment indicates that this was not a new tax, but a correction necessary to effectuate Congress' intent in enacting [the Tax Equity and Fiscal Responsibility Act of 1982]." *Id.*

Although Notice 87-13 did not carry the authority of binding law, it did notify taxpayers of the possibility that section 2057 would be amended, how section 2057 might be amended, and the fact that there was risk associated with entering into transactions solely out of reliance upon section 2057. To hold that Notice 87-13 had no such effect would be to invite taxpayers to use such notices – which, as is established in the record, are issued by the IRS to inform Congress of its errors in drafting tax legislation – to locate Congress' mistakes and exploit them before they are corrected. Moreover, although one month may not constitute abundant notice, Ferman and her attorneys had every reason to remain observant for signs of change to section 2057. Specifically, although the transactions at issue cost the decedent's estate $49,057.50 in the form of deductions given to the ALZA ESOP, these transactions, in the absence of an amendment to section 2057, subjected the estate to a relatively low amount of risk and reduced its taxable amount by $466,046.25, or twenty-five percent. The result was a $177,362.03 reduction in federal estate tax. Although it is indisputable that section 2057 was passed to encourage the growth of ESOPs, the transactions at issue brought about an immediate benefit to the estate – and cost to the federal government through lost tax revenue – that was nearly four times greater than the deductions received by the ALZA ESOP.[10] Accordingly,

[10] As stated by Judge Norris in his dissent to the *Carlton* majority opinion,

> [T]he statute on its face offered a benefit that appeared "too good to be true." Admittedly, a number of laws provide tax incentives to encourage the growth of ESOPs, in some cases subsidizing third parties for facilitating the transfer of employer

we conclude that Notice 87-13 reasonably forewarned Ferman and her attorneys of Congress' amendment to section 2057. *See Milliken v. United States,* 283 U.S. 15, 21-24, 51 S.Ct. 324, 327, 75 L.Ed. 809 (1931) (upholding a retroactive gift tax where the donor was forewarned of the possibility of this tax); *Estate of Ekins v. Commissioner,* 797 F.2d 481, 484 (7th Cir.1986) ("[T]he application of a tax statute will not amount to a deprivation of property without due process of law if it meets two tests: the change is reasonably foreseeable and is only a fluctuation in the tax rate instead of a wholly new tax.").

Second, in amending section 2057, Congress was careful not to completely eliminate the deduction for taxpayers who relied upon it in their estate planning, as indicated by their (1) directly purchasing the securities before their deaths and (2) providing that these securities be allocated or held for future allocation in specified ways. *See* Pub.L. No. 100-203 § 10411, 101 Stat. 1330, 1330-432 (1987).[11] The transactions at issue in the case

securities to an ESOP. . . . But the outcome in this case . . . demonstrates that the deduction as drafted offered a subsidy of a wholly different magnitude from existing provisions. Congress could more providently have underwritten ESOP stock purchases directly from the U.S. Treasury without bringing in estate executors as middlemen!

972 F.2d at 1066.

[11] Section 10411(d) provides that:

(1) *In general.* – For purposes of this section, the proceeds of a sale of employer securities by an executor to an employee stock ownership plan or an eligible worker-owned cooperative shall not be treated as qualified proceeds from a qualified sale unless –

before us, rather than being part of Paglin's estate planning, were entered into after his death solely to take advantage of the deduction offered under section 2057.

When regulating economic activity, Congress generally enjoys wide latitude to legislate retroactively. *See Pension Benefit Guaranty Corp. v. R.A. Gray & Co.,* 467 U.S. 717, 729, 104 S.Ct. 2709, 2717-18, 81 L.Ed.2d 601 (1984);[12] *see also supra* note 5 (equating the standards of review for the retroactive application of statutes in and outside of the tax context). Moreover, the Supreme Court observed long ago that "[n]o more essential or important power has been conferred upon the Congress [than the power to collect taxes and raise revenues,] and the presumption that an Act of Congress is valid applies with added force

(A) the decedent directly owned the securities immediately before death, and

(B) after the sale, the employer securities –

(i) are allocated to participants, or

(ii) are held for future allocation in connection with

(I) an exempt loan under the rules of section 4975, or

(II) a transfer of assets under the rules of section 4980(c)(3).

[12] In *Pension,* the Court explained that:

the strong deference accorded legislation in the field of national economic policy is no less applicable when that legislation is applied retroactively. Provided that the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches. . . .

467 U.S. at 729, 104 S.Ct. at 2717-18.

and weight to a levy of public revenue." *United States v. Jacobs*, 306 U.S. 363, 370, 59 S.Ct. 551, 555, 83 L.Ed. 763 (1939) (footnote omitted). Although Congress acted retroactively when amending section 2057, it was merely correcting a substantial error[13] publicly acknowledged through Notice 87-13 just three months after that error was made. Proposed legislation confirming the position taken by the IRS in Notice 87-13 was introduced into Congress the following month. And, at the time section 2057 was actually amended (just one week after Ferman filed a refund claim with the IRS for $177,362.03), the deduction had been in existence for just a little more than one year. *See Wiggins*, 904 F.2d at 315 (in upholding a corrective tax statute applied retroactively, stating that "[w]here legislation is curative, retroactive application may be constitutional despite a long period of retroactivity"); *cf. United States v. Hudson*, 299 U.S. 498, 500, 57 S.Ct. 309, 310, 81 L.Ed. 370 (1937) ("[I]t long has been the practice of Congress to make [income tax statutes] . . . retroactive for relatively short periods so as to include profits from transactions consummated while the statute was in process of enactment. . . . ") (citations omitted). Having analyzed the effect of Congress' retroactive amendment to section 2057 in the context of the facts before us, we conclude that limiting the scope of section

[13] Congress anticipated that the revenue loss resulting from the passage of section 2057 would be approximately $300 million. Because section 2057 was not specifically limited to instances where the decedent owned the employer securities at the time of his or her death, the potential revenue loss resulting from 2057 as originally drafted was estimated at $7 billion. *See* 133 Cong.Rec. H845 (daily ed. Feb. 26, 1987).

2057 to exclude the transactions at issue in this case does not constitute a change in tax law "so harsh and oppressive as to transgress the constitutional limitation." *Hemme*, 476 U.S. at 568-69, 106 S.Ct. at 2078; *Welch*, 305 U.S. at 147, 59 S.Ct. at 125.

III. CONCLUSION

For the foregoing reasons, we AFFIRM the district court's grant of summary judgment in favor of the government.

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No. 92-1941

In the Supreme Court of the United States

OCTOBER TERM, 1993

UNITED STATES OF AMERICA, PETITIONER

v.

JERRY W. CARLTON

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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Respondent devotes the bulk of the brief in opposition to the contention that this case turns solely on a question of fact (Br. in Opp. 6-14). Respondent claims that the "fact-bound determination" (*id.* at 14) that controls this case is simply whether, or not, respondent had "constructive notice" of the curative change that Congress enacted to Section 2057. See also Br. in Opp. 19, 27. Building upon this inaccurate description of the question presented and decided by the courts below, respondent claims that the decision of the court of appeals is "narrowly written" and merely applies settled law to the particular facts of this case (*id.* at 27).

Respondent's description of the decision cannot be reconciled with the words of the court's opinion. It

also manifestly undervalues the importance of the issues at stake.

1. The constitutional standard for testing the validity of retroactive legislation under the Due Process Clause is not—and has never been—whether or not the taxpayer had "constructive notice" of the change. Courts have sometimes noted, as a matter of law (not of fact), that taxpayers "must be prepared" for the possibility of changes in the tax laws and that "[n]obody has a vested right in the rate of taxation" (*Cohan* v. *Commissioner*, 39 F.2d 540, 545 (2d Cir. 1930) (L. Hand, J.)). But the constitutional standard, clearly described in this Court's opinions, is "met simply by showing that the retroactive application of the legislation" is rationally designed to accomplish a "legitimate legislative purpose" (*Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. 717, 729, 730 (1984)). Accord, *United States* v. *Sperry Corp.*, 493 U.S. 52, 64-65 (1989).

Accordingly, the Court has emphasized on several occasions that retroactive legislation—even without any notice, constructive or otherwise—"is not unlawful solely because it upsets otherwise settled expectations" (*Concrete Pipe & Products of California, Inc.* v. *Construction Laborers Pension Trust*, No. 91-904 (June 14, 1993), slip op. 34, quoting *Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 729-730). See also *Usery* v. *Turner Elkhorn Mining Co.*, 428 U.S. 1, 15-16 (1976). Retroactive curative legislation that is designed to correct acknowledged errors in prior enactments is properly and routinely upheld under the Due Process Clause because its retroactivity is rationally designed to accomplish legitimate governmental interests. See, *e.g.*, *Graham & Foster* v. *Goodcell*, 282 U.S. 409, 428 (1931) (Congress's

"power to enact curative statutes" is "unquestionably valid") (quoting *United States* v. *Heinszen & Co.*, 206 U.S. 370, 387 (1907)). See also Pet. 14-16 & n.10. Respondent errs in ignoring this controlling body of case law and in seeking to characterize the decision below as simply a "fact-bound determination" concerning the presence or absence of "constructive notice" of the changed law (Br. in Opp. 14).

2. Respondent also errs in suggesting that the decision of the court of appeals is "narrowly written" (Br. in Opp. 27). To the contrary, in an effort to avoid the modern holdings of this Court, the court of appeals has struggled to justify a new and unsupported three-part due process test that looks to (i) whether the taxpayer had "actual or constructive notice that the tax statute would be retroactively amended" (Pet. App. 17a), (ii) whether the taxpayer relied "to his detriment on the pre-amendment tax statute" (*ibid.*), and (iii) whether such reliance was "reasonable" (*ibid.*). Implicitly recognizing that this formula has no support in the Constitution or this Court's decisions, respondent makes no effort to justify (or even to address) it.

Instead, respondent makes the broad (and equally unsupported) assertion that retroactive tax legislation without "notice" to the public is inherently unfair and is therefore "arbitrary and irrational" (Br. in Opp. 22). Evading this Court's due process decisions entirely, respondent seeks to rely on academic writings concerning other provisions of the Constitution which generally suggest that the "government must keep its word" (*id.* at 23).

Legislation is not a promise. Legislation seeks to accomplish public objectives through mandatory standards. When Congress makes a mistake in the phrasing of its legislation, it is in the public interest for that mistake to be corrected. This Court has recognized this fact by endorsing the "unquestionably valid" power of Congress to "enact curative statutes" (*Graham & Foster* v. *Goodcell*, 282 U.S. at 428).

The decision of the court of appeals, and the unsupported three-part test that it adopts, seeks to turn the Due Process Clause into a promissory estoppel clause. It cannot reasonably be suggested that the court of appeals' effort to engage in such a drastic revision of basic constitutional principles reflects a "narrowly written" decisional approach.

Moreover, while, in our view, it is not relevant to the constitutionality of the statute involved in this case, we note that respondent does not dispute that the claimed "detrimental reliance" of the taxpayer on the original language of the statute is largely illusory. As the petition points out, by engaging in market transactions in MCI stock, respondent could have made a profit as easily as a loss (Pet. 4 n.6 & 21).

Respondent claims that, but for the statute, he would not have made the sale to the corporation at a "below-market" (Br. in Opp. 22) discount of 26 cents per share (Pet. App. 4a). But, as we have explained (Pet. 4 n.6), and as respondent does not dispute, if respondent had purchased the MCI shares only a few days earlier and sold the stock with the same discount on the same day that the sale in fact occurred, respondent would have made a profit of $825,000 on

the transaction instead of a "loss" of $631,000. It was the timing of respondent's purchases, not the inevitable application of the statute, that produced the "loss" for the estate. In either situation, the amount of the claimed deduction under Section 2057 would be the same (Pet. 6 n.4).

Under the court of appeals' theory, the retroactive amendment to Section 2057 would evidently have been constitutional if respondent had purchased the MCI stock on December 3, 1986, instead of on December 10, 1986, for respondent would then have no "detriment" of which to complain. There is no precedent for such wavering constitutional guidelines for retroactive legislation.

3. For the reasons we explain in the petition (Pet. 23-24), the decision in this case merits this Court's review. The court of appeals has held a statute of Congress unconstitutional. In doing so, the court has adopted a novel constitutional test that imposes evidently insurmountable obstacles to ordinary legislative action. In this year, like most others, Congress is in the process of adopting extensive revisions to the tax laws. There is often little if any advance warning of the details of such legislation: changes in proposed tax provisions are often made (and entirely new provisions are often added) in Conference Committee without any public notice. It is a common practice for such revisions to be retroactive in varying degrees. The decision of the court of appeals in this case threatens substantially to interfere with the ordinary enforcement of such revenue laws in a circuit that encompasses a large portion of our Nation's taxpayers and economic activity.

For the foregoing reasons, and those stated in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

DREW S. DAYS, III
Solicitor General

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No. 92-1941

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v.

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BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

Whether curative legislation proposed in January 1987 and enacted in December 1987 retroactively to avert the potential abuse of an estate tax provision enacted in October 1986 violates due process when applied to a transaction entered into by an estate in December 1986.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-36a) is reported at 972 F.2d 1051. The opinion of the district court (Pet. App. 38a-42a) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on August 10, 1992. A petition for rehearing with suggestion for rehearing *en banc* was denied on March 9, 1993 (Pet. App. 37a). The petition for a writ of certiorari was filed on June 7, 1993, and was granted on October 4, 1993. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATUTES AND REGULATIONS INVOLVED

The relevant portions of Section 2057 of the Internal Revenue Code of 1986, as originally enacted, and as amended by Section 10411 of the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330-432 to 1330-433, are set forth at Pet. App. 43a-46a.

STATEMENT

1. This case concerns the estate tax liability of the estate of Willametta K. Day, who died on September 29, 1985. The estate tax return for her estate was initially due on June 29, 1986.[1] Respondent (the executor of Ms. Day's will) sought and obtained a six-month extension for the filing of the return.[2] The return was therefore due on December 29, 1986 (Pet. App. 4a).

During the period of this six-month filing extension, Congress enacted the major revisions to the Internal Revenue Code contained in the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085. Section 1172 of that Act added a new estate tax provision applicable to estates that filed timely returns after the date of the Act, October 22, 1986. See 100 Stat. 2513-2515. The new estate tax provision was codified as Section 2057 of the Internal Revenue Code of 1986, 26 U.S.C. 2057 (Supp. IV 1986).[3] It established a deduction for estate tax purposes of one-half of the proceeds of "any sale of employer securities by the executor of an estate" to "an employee stock ownership plan" (26 U.S.C. 2057(a), (b) (Supp. IV 1986)).[4] To qualify for the new estate tax deduction under Section 2057, the sale of securities had to be made by the executor "before the date on which the [estate tax] return * * * is required to be filed (including any extensions)." 26 U.S.C. 2057(c)(1) (Supp. IV 1986).

2. Respondent sought to take advantage of this new provision in the following manner: (i) on December 10, 1986, more than a year after decedent's death and less than three weeks before filing the delayed estate tax return, respondent used estate funds to purchase 1,500,000 shares of the stock of MCI Communications Corporation (MCI) for $11,206,000 (representing an average price of $7.47 per share);[5] (ii) two days later, on December 12, 1986, respondent sold the MCI stock to the MCI Employee Stock Ownership Plan for $10,575,000 (representing an average price of $7.05 per share); and (iii) based on these transactions, respondent claimed a deduction under Section 2057 of one-half of the proceeds of the sale of stock to the MCI plan (or $5,287,000) on the estate tax return which he filed on December 29, 1986. The result of the claimed deduction was to reduce the reported estate tax obligation by $2,501,161 (Pet. App.

[1] Under Section 6075(a) of the Internal Revenue Code, the estate tax return is to be filed within nine months of the decedent's death. 26 U.S.C. 6075(a).

[2] The Secretary may allow extensions of time for the filing of any return. But "no such extension shall be for more than 6 months." 26 U.S.C. 6081(a).

[3] Section 2057 was repealed for the estates of persons dying after December 19, 1989. See Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7304(a), 103 Stat. 2352-2353.

[4] The term "employer securities" is defined in Section 2057 by reference to Section 409(*l*) of the Code, 26 U.S.C. 409(*l*) (Supp. IV 1986). In general, the term means common stock issued by the employer that is readily tradeable on an established securities market. See 26 U.S.C. 2057(e) (Supp. IV 1986).

[5] In December 1986, MCI was a publicly traded stock listed on the NASDAQ exchange. Its daily trading volume during this period was several million shares. See, *e.g.*, Wall St. J., Dec. 5, 1986, at 56; *id.*, Dec. 3, 1986, at 54; *id.*, Dec. 2, 1986, at 64.

4a-5a, 7a).[6]

3. On January 5, 1987, the Internal Revenue Service announced that it was seeking curative legislation to clarify that the deduction under Section 2057 was available only to estates of decedents who owned the securities in question *prior* to death. Notice 87-13, 1987-1 C.B. 432, 442. A bill to enact this proposed amendment to Section 2057 was introduced in both chambers of Congress on February 26, 1987. 133 Cong. Rec. 4145 (1987); 133 Cong. Rec. 4293 (1987).

When Section 2057 was originally enacted in 1986, Congress anticipated that the resulting benefit to taxpayers from this provision would be approximately $300 million. 133 Cong. Rec. 4145 (1987). As Representative

[6] By purchasing the 1,500,000 shares of MCI stock at a market price of approximately $7.47 per share on December 10, 1986, and selling the stock at $7.05 per share to the MCI ESOP on December 12, 1986, the estate lost $631,000 on the transaction (Pet. App. 4a-5a). But this loss was neither inevitable nor relevant to the claimed deduction.

The market price for MCI stock prevailing a few days earlier—on December 1 and December 2, 1986—was $6.50 per share. See Wall St. J., Dec. 2, 1986, at 64; *id.*, Dec. 3, 1986, at 54. If respondent had made his purchases on those dates at the market price of $6.50 per share, and had made the same sale of stock to the MCI plan on December 12, 1986, at the price of $7.05 per share which he in fact realized, the estate would have made a profit of $825,000 on the transaction. Even in that situation, however, the estate could still have claimed the same estate tax deduction of $5,287,500 under Section 2057, because the Section 2057 deduction is simply computed as one-half of the sale price. See 26 U.S.C. 2057(a) (Supp. IV 1986). Whether the estate made a profit or a loss on the sale is irrelevant to the deduction under Section 2057.

This case does not present the question of the proper tax treatment of the "loss" of $631,000 resulting from the purchase and sale of the MCI stock. Only the estate tax deduction (for one-half of the sale proceeds) under Section 2057 is at issue.

Rostenkowski, the Chairman of the House Ways and Means Committee, noted in introducing the 1987 amendment, however, it became clear shortly after passage of the 1986 Act that the projected revenue loss under Section 2057 could be as much as $7,000,000,000—more than 20 times the amount originally anticipated—because the statute did not explicitly limit the deduction to instances where the decedent owned the employee securities at the time of death (*ibid.*).[7] Senator Bentsen, the Chairman of the Senate Finance Committee, observed that "Congress did not intend for estates to be able to claim the deduction by virtue of purchasing stock in the market and simply reselling the stock to an ESOP" (133 Cong. Rec. 4294 (1987)). The provision had not been intended to permit a deduction for "essentially sham transactions" (*ibid.*).

The Committee Report on enactment of the 1987 amendment states that, "[w]hile Congress intended to encourage transfers of employer securities to ESOPs by providing for partial elimination of estate tax liability, it was not intended that estates be able to eliminate all estate tax liability through use of the deduction" (H.R. Rep. No. 391, 100th Cong., 1st Sess. Pt. II, at 1045

[7] Representative Rostenkowski noted that the 1987 amendment to Section 2057 effected the "congressional intent in enacting the [original] provision." 133 Cong. Rec. 4145 (1987). The Staff of the Joint Committee on Taxation had reported, in connection with the original enactment of Section 2057, that the provision was designed to create an "incentive for stockholders to sell their companies to their employees who helped them build the company rather than liquidate, sell to outsiders or have the corporation redeem their shares on behalf of existing shareholders." Staff of the Joint Comm. on Taxation, 99th Cong., 2d Sess., *Tax Reform Proposals: Tax Treatment of Employee Stock Ownership Plans (ESOPs)* 37 (Comm. Print 1985). See also 132 Cong. Rec. 14,507 (1986) (statement of Sen. Long).

(1987)). The Report concludes that "[t]he provision would not have been adopted in its present form had the full extent of the revenue impact and the effect of the provision been recognized" (*ibid.*). The Report explains that the modifications contained in the bill are designed "to bring the revenue loss in line with the original estimate and Congressional intent" (*ibid.*).

The curative amendment to Section 2057 was enacted on December 22, 1987. The amendment was made effective as if it had been contained in the statute as originally enacted in October 1986. See Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10411, 101 Stat. 1330-432 to 1330-433. The statute as amended in 1987 provides that, to qualify for the estate tax deduction under Section 2057, the securities sold to the employee stock ownership plan must have been "directly owned" by the decedent "immediately before death" (Pub. L. No. 100-203, § 10411(a), 101 Stat. 1330-432; see also 26 U.S.C. 2057 note (Supp. V 1987)).[8]

4. The Internal Revenue Service disallowed the claimed deduction for the sale of MCI stock on Ms. Day's estate tax return because the stock had been purchased after Ms. Day's death and was not owned by her "immediately before death." Respondent paid the resulting estate tax deficiency of $2,501,161, plus interest, and commenced this suit for refund in federal district court (Pet. App. 5a, 7a).

Respondent acknowledged that the estate did not qualify for the deduction under the amended provisions of Section 2057. Respondent contended, however, that the estate qualified for the deduction under the original

[8] A complementary, prospectively applicable provision was enacted at the same time. See 26 U.S.C. 2057 (Supp. V 1987); Pub. L. No. 100-203, §§ 10411(b), 10412, 101 Stat. 1330-433 to 1330-436.

provisions of Section 2057 and that the 1987 amendment to that statute could not constitutionally be applied retroactively. Respondent asserted that retroactive application of the 1987 amendment to the estate's 1986 transactions in MCI stock violated the Due Process Clause of the Fifth Amendment to the Constitution (Pet. App. 7a-8a).

The district court rejected respondent's due process claim (Pet. App. 39a-41a). The court emphasized that "the Supreme Court has expressed doubt that foreseeability of retroactive legislation is even a 'relevant consideration' in Due Process Clause analysis" (Pet. App. 40a (quoting *Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. 717, 731-732 (1984)). Even assuming the relevance of foreseeability of the change, the court noted that "changes in tax laws are 'by [their] very nature . . . reasonably foreseeable'" and "the taxpayer assumes the risk that the tax burden on a particular transaction may increase pursuant to Congress' continual responsibility to carry out the necessary policies of taxation" (Pet. App. 40a (quoting *Estate of Ekins* v. *Commissioner*, 797 F.2d 481, 483, 484 (7th Cir. 1986)). The court concluded that, while a taxing statute that retroactively imposes a wholly new tax may be challenged under the Due Process Clause, a retroactive "amendment[ ] that bring[s] about certain changes in operation of the tax laws, rather than the creation of a wholly new tax," is not constitutionally defective (Pet. App. 41a (quoting *United States* v. *Hemme*, 476 U.S. 558, 568 (1986)). The court held that the effect of the 1987 amendment on the availability of the Section 2057 deduction was not "harsh and oppressive" and that "retroactive application of the amendments to § 2057 [therefore] does not violate due process" (Pet. App. 39a, 40a).

5. A divided panel of the court of appeals reversed (Pet. App. 1a-36a). The court acknowledged at the outset that "retroactivity alone will not condemn a congressional enactment" (*id.* at 10a). The court rejected, however, "the notion of a per se rule that tax statutes can *always* be retroactively applied so long as they do not enact a 'wholly new' tax" (*ibid.*). The court concluded that the relevant inquiry under the Due Process Clause is whether "retroactive application is so harsh and oppressive as to transgress the constitutional limitation" (*id.* at 9a (quoting *United States* v. *Hemme,* 476 U.S. at 568-569)). In determining whether retroactive application of the 1987 amendment was "harsh and oppressive," the court looked to (i) whether "the taxpayer ha[d] actual or constructive notice that the tax statute would be retroactively amended" (Pet. App. 17a), (ii) whether "the taxpayer rel[ied] to his detriment on the pre-amendment tax statute" (*ibid.*), and (iii) whether such reliance was "reasonable" (*ibid.*).

The court concluded that retroactive application of the 1987 amendment violated due process because each of these three criteria was met in this case. Respondent lacked actual or constructive notice that the statute would be amended retroactively because "no act of the executive or legislative branch would have given any forwarning of the 1987 amendment at the time the MCI ESOP transaction occurred" (Pet. App. 17a-18a).[9] The court reasoned that respondent had "detrimentally relied on section 2057 as [originally] enacted" (*id.* at 19a) because he had "engaged in a costly transaction for no other reason than the inducement provided by the new section 2057" (*ibid.*). Although denial of the Section 2057 deduction would not detrimentally affect the estate's tax liability—for the taxes owed would be no greater than "if the ESOP proceeds deduction had never been enacted in the first place" (*id.* at 22a)—the court asserted that this "fails to account for the actual loss suffered by the estate" (*ibid.*):

> It was too late for [respondent] to undo his sale to the MCI ESOP. The $631,000 [loss on respondent's purchase and sale of MCI stock] was gone forever, irretrievable. [Pet. App. 19a.]

The court reasoned that this $631,000 loss represented the type of "detrimental reliance" that made retroactive application of the 1987 amendment unconstitutional (*ibid.*).

Finally, the court concluded that "the estate's reliance on the plain language of section 2057 was reasonable in light of the lack of any indication that an amendment was in the offing and in the context of the large tax incentives Congress has given to ESOPs" (Pet. App. 23a). Due to what it termed the reasonable, detrimental reliance of the estate and the unforeseeability of the amendment, the court concluded that retroactive application of the 1987 amendment to Section 2057, "as applied here, * * * is 'so harsh and oppressive as to transgress the constitutional limitation' " (Pet. App. 24a).

Judge Norris dissented (Pet. App. 25a-36a). He pointed out that deductions are purely a matter of legislative grace and that Congress has full power to revoke such benefits retroactively (*id.* at 30a (citing *Miller* v. *Com-*

[9] The amendments to Section 2057 were proposed to Congress in January 1987 and were enacted in December 1987. The court of appeals stated that "[w]e do not doubt the power of Congress to apply legislation retroactively to the time such legislation was introduced, or even to the time such legislation was proposed by the executive branch. * * * During this time period, the taxpayer is on notice that a change in law is forthcoming." Pet. App. 24a.

missioner, 115 F.2d 479, 480 (9th Cir. 1940), cert. denied, 312 U.S. 703 (1941)). He further noted that "[t]he Supreme Court and our sister circuits have made clear * * * that constructive notice to the taxpayer is usually implied for a change in the rate or basis of an existing tax" (Pet. App. 29a). He concluded that "[t]he majority, in reaching a different conclusion, creates a split among the circuits, as well as a conflict with our own, older precedent" (*id.* at 30a):

> I recognize that, if this case raised a question of statutory interpretation, neither the provision's legislative history nor its unfortunate economic effects could detract from the plain meaning of the text [of the original statute]. * * * But this case does not require us to interpret the 1986 statute, only to inquire whether Congress, in amending it, acted in an arbitrary and capricious manner, or "so harsh[ly] and oppressive[ly] as to transgress the constitutional limitation." [*Welch* v. *Henry*, 305 U.S. 134, 147 (1938)]. Because Congress's retroactive legislation limited the scope of a loophole that had been in effect just over one year, it did not transgress that boundary. [Pet. App. 35a-36a.]

SUMMARY OF ARGUMENT

The three-part substantive due process test adopted by the court of appeals departs from this Court's holdings and lacks any basis in the Constitution. The burden of sustaining retroactive legislation under the Due Process Clause is "met simply by showing that the retroactive application of the legislation is itself justified by a rational legislative purpose." *Pension Benefit Guar-*

anty Corp. v. *R.A. Gray & Co.*, 467 U.S. 717, 730 (1984). Retroactive tax legislation rationally drawn to achieve a legitimate legislative purpose does not violate the Due Process Clause even if the statute imposes a liability that "was not anticipated" or "upsets otherwise settled expectations" and "even though the effect of the legislation is to impose a new duty or liability based on past acts." *Usery* v. *Turner Elkhorn Mining Co.*, 428 U.S. 1, 16 (1976). See also *Welch* v. *Henry*, 305 U.S. 134, 146-149 (1938).

Measured against this proper standard, the 1987 amendment to Section 2057 of the Internal Revenue Code does not offend due process. Retroactive application of the amendment to the date the statute was originally enacted represents a rational method of accomplishing a legitimate governmental purpose. The original phrasing of the statute made its benefits potentially available to estates whose transactions had no purpose other than tax avoidance. Congress had not intended to permit a deduction for such "essentially sham transactions" (133 Cong. Rec. 4294 (1987) (Sen. Bentsen)) and it was therefore necessary for Congress promptly and retroactively to correct the legislation that, on its face, permitted such patent abuse.

Legislation designed to cure errors in the drafting of tax legislation, and to close loopholes unintentionally created in the legislative process, is an especially fit subject for retroactive, as well as prospective, treatment. This Court has long recognized that Congress's "power to enact curative statutes" is "unquestionably valid." *Graham & Foster* v. *Goodcell*, 282 U.S. 409, 428 (1931).

ARGUMENT

I. THE 1987 AMENDMENT TO SECTION 2057 OF THE INTERNAL REVENUE CODE SATISFIES THE REQUIREMENTS OF DUE PROCESS BECAUSE IT CONSTITUTES A RATIONAL MEANS TO FURTHER A LEGITIMATE LEGISLATIVE PURPOSE

The decision of the court of appeals adopts and applies a novel and erroneous three-step substantive due process test for determining the constitutionality of retroactive tax legislation. The court's new test conflicts with the standards articulated under the Due Process Clause by this Court and by the other courts of appeals.

1. The "guaranty of due process" in the regulation of commercial matters "demands only that the law shall not be unreasonable, arbitrary or capricious, and that the means selected shall have a real and substantial relation to the object sought to be attained." *Nebbia* v. *New York*, 291 U.S. 502, 525 (1934). As this Court stated in *Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 729:

> [T]he strong deference accorded legislation in the field of national economic policy is no less applicable when that legislation is applied retroactively. Provided that the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches.

The burden of sustaining retroactive legislation under the Due Process Clause is therefore "met simply by showing that the retroactive application of the legislation is itself justified by a rational legislative purpose." *Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 730. Accord, *United States* v. *Sperry Corp.*, 493 U.S. 52, 64-65 (1989). Whether a "wiser or more practical" approach might be thought desirable "is not a question of constitutional dimension." *Usery* v. *Turner Elkhorn Mining Co.*, 428 U.S. at 19.[10]

Even when "[r]etroactive legislation presents problems of unfairness that are more serious than those

[10] Prior to *Nichols* v. *Coolidge*, 274 U.S. 531 (1927), "no federal revenue measure ha[d] ever been held invalid on the score of retroactivity." *Untermyer* v. *Anderson*, 276 U.S. 440, 449 (1928) (Brandeis, J., dissenting). In a series of cases in the late 1920's, however, the Court invalidated the retroactive application of certain taxes that the Court found to be "wholly unreasonable" (*Blodgett* v. *Holden*, 275 U.S. 142, 147 (1927) (opinion of McReynolds, J.)) and "whimsical and burdensome" (*Nichols* v. *Coolidge*, 274 U.S. at 542). In dissenting from the Court's holding in *Untermyer* that various retroactive features of the gift tax violated the Due Process Clause, Justice Holmes stated (276 U.S. at 446):

> I find it hard to state to myself articulately the ground for denying the power of Congress to lay the tax. We all know that we shall get a tax bill every year. * * * A tax may be levied for past privileges and protection as well as for those to come.

Justice Brandeis wrote a separate dissent in the *Untermyer* case, concluding that the Court had invalidated the retroactive features of the federal gift tax simply "because the action of the law-making body is, in its opinion, unreasonable." 276 U.S. at 447. Justice Brandeis stated that, "[f]or more than half a century, it has been settled that a law of Congress imposing a tax may be retroactive in its operation" and that in numerous instances an "additional tax [had been] imposed after the taxes for the year had been paid." *Id.* at 447, 448. Justice Brandeis noted, moreover, that the retroactive features of the challenged statute had "a special justification" because they were designed to prevent evasions of the tax. *Id.* at 450. As Justice Brandeis queried, in a comment also applicable to the present case, "Is Congress powerless to prevent such evasion by the vigilant and ingenious?" *Id.* at 450-451.

posed by prospective legislation" (*General Motors Corp.* v. *Romein,* 112 S.Ct. 1105, 1112 (1992)), "the test of due process" for the "retroactive aspects of [economic] legislation, as well as the prospective aspects," is whether they advance "a legitimate legislative purpose * * * by rational means." *Ibid.*, quoting *Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 730. While the Court has stated that "retrospective civil legislation may offend due process if it is 'particularly "harsh and oppressive"' " (*Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 733, quoting *United States Trust Co.* v. *New Jersey,* 431 U.S. 1, 17 n.13 (1977), quoting *Welch* v. *Henry,* 305 U.S. at 147), this does not permit courts to reweigh the wisdom or fairness of the legislation (*Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 729). Instead, the requirement that retroactive legislation not be "harsh and oppressive" is "met simply by showing that the retroactive application of the legislation" is rationally designed to accomplish a legitimate legislative purpose (*id.* at 730, 733). See *Usery* v. *Turner Elkhorn Mining Co.*, 428 U.S. at 16. Retroactive legislation rationally drawn to achieve a legitimate purpose does not violate the Due Process Clause even if the statute imposes a liability that "was not anticipated" or "upsets otherwise settled expectations" and "even though the effect of the legislation is to impose a new duty or liability based on past acts." *Ibid.* Accord, *Concrete Pipe & Products of California, Inc.* v. *Construction Laborers Pension Trust,* 113 S. Ct. 2264, 2287 (1993); *General Motors Corp.* v. *Romein,* 112 S. Ct. at 1112; *United States* v. *Sperry Corp.*, 493 U.S. at 64-65.

2. Legislation designed to cure errors in the drafting of tax legislation, and to close loopholes unintentionally

created in the legislative process, is an especially fit subject for retroactive, as well as prospective, treatment. It is a particular manifestation of the broad discretion vested in Congress to decide which groups of taxpayers are sufficiently similarly situated to warrant similar treatment. Congress unquestionably has a legitimate interest in designing revenue laws to fairly allocate to taxpayers the burdens and benefits of national fiscal policies and to prevent evasion of those laws "by the vigilant and ingenious" (see note 10, *supra*). If an unintended loophole is written into an enacted statute, and if Congress acts promptly to correct that error through curative legislation, it cannot be said that retroactive correction of the error lacks a rational relationship to the government's legitimate legislative objective. A curative, retroactive statute rationally designed to accomplish that legitimate purpose satisfies the requirements of due process. See *Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 729, 733. See also *Graham & Foster* v. *Goodcell,* 282 U.S. 409, 428 (1931) (Congress's "power to enact curative statutes" is "unquestionably valid") (quoting *United States* v. *Heinszen & Co.*, 206 U.S. 370, 387 (1907) (upholding statute that ratified tariff duties collected eight years previously without authority)).[11]

[11] Even aside from the special justifications applicable to curative legislation, this Court has repeatedly upheld retroactive tax legislation. See, *e.g.*, *United States* v. *Hemme,* 476 U.S. 558, 566-567 (1986); *United States* v. *Darusmont,* 449 U.S. 292, 296-299 (1981); *Welch* v. *Henry,* 305 U.S. at 146-150; *United States* v. *Hudson,* 299 U.S. 498, 501 (1937); *Milliken* v. *United States,* 283 U.S. 15, 24 (1931); *Cooper* v. *United States,* 280 U.S. 409, 411 (1930); note 10, *supra*. Referring to the constitutional power to lay and collect taxes, the Court has observed that "[n]o more essential or important power has been conferred upon the Congress and

For this reason, "[c]ourts have consistently upheld the retroactive application of 'curative' legislation which corrects defects subsequently discovered in a statute and which restores what Congress had always believed the law to be" (*Long* v. *IRS*, 742 F.2d 1173, 1183 (9th Cir. 1984) (upholding retroactive amendment to the definition of "return information" under Section 6103 of the Code).[12] If Congress were unable retroactively to correct

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the presumption that an Act of Congress is valid applies with added force and weight to a levy of public revenue" (*United States* v. *Jacobs*, 306 U.S. 363, 370 (1939)). Retroactivity is a common feature of tax legislation. "Congress almost without exception has given each such statute an effective date prior to the date of actual enactment." *United States* v. *Darusmont*, 449 U.S. at 296.

[12] Courts routinely have upheld such retroactive tax legislation. Among the many statutes considered and upheld are: (i) legislation including amounts withheld from employees' wages in the social security wage base (*New England Baptist Hospital* v. *United States*, 807 F.2d 280, 285 (1st Cir. 1986); *Canisius College* v. *United States*, 799 F.2d 18, 27 (2d Cir. 1986), cert. denied, 481 U.S. 1014 (1987); *Temple University* v. *United States*, 769 F.2d 126, 135 (3d Cir. 1985), cert. denied, 476 U.S. 1182 (1986)); (ii) legislation clarifying that the annual gift tax exclusion applied only to gifts valued at less than $3,000, and that the amount of the annual exclusion was not deductible from the value of gifts over that amount (*Reed* v. *United States*, 743 F.2d 481 (7th Cir. 1984), cert. denied, 471 U.S. 1135 (1985); *Estate of Ceppi* v. *Commissioner*, 698 F.2d 17, 21 (1st Cir.), cert. denied, 462 U.S. 1120 (1983)); (iii) a retroactive amendment clarifying that investment credit recapture is not to be taken into account in computing minimum tax liability (*Wiggins* v. *Commissioner*, 904 F.2d 311, 314 (5th Cir. 1990) ("We do not see how a new tax has been imposed by eliminating a loophole"); (iv) the retroactive elimination of the applicability of the annual gift tax exclusion to transfers of interests in life insurance (*Estate of Ekins* v. *Commissioner*, 797 F.2d at 484-485; *Fein* v. *United States*, 730 F.2d 1211, 1213-1214 (8th Cir.), cert. denied, 469 U.S. 858 (1984)); and (v) an

loopholes unintentionally enacted in revenue laws, it would be left "powerless to carry out the yearly tinkering with the Code that is necessary to prevent losses of revenue and secure the national fiscal goal" (*Estate of Ekins* v. *Commissioner*, 797 F.2d at 485).

3. Measured by this proper standard, the 1987 amendment to Section 2057 does not offend due process. Retroactive application of the amendment to the date the statute was originally enacted (in October 1986) represents a rational method of accomplishing a legitimate governmental purpose.

Soon after the original enactment of Section 2057, Congress discovered that the statute contained an unintended loophole that threatened a staggering revenue loss. Congress had never contemplated application of the Section 2057 deduction to post-death purchases and sales of securities by estate administrators. Application of the statute in that manner vastly expanded the scope and effect of the deduction. See pages 4-5, *supra*. Absent any amendment, the statute would ostensibly permit estate tax deductions for transactions that had no purpose other than tax avoidance.[13] But Congress "did not

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amendment to Section 6621 retroactively clarifying, in the wake of an adverse court decision, that the increased rate of interest applicable to tax-motivated transactions applies to sham transactions (*De Martino* v. *Commissioner*, 862 F.2d 400, 408 (2d Cir. 1988)).

[13] The original statute, on its face, could be read to allow any estate to obtain a deduction for its estate tax return (and even to eliminate its estate tax entirely) simply by purchasing employer securities on the open market and reselling them to an employer ESOP. Since the estate would claim a deduction for one-half of the proceeds of the sale from such a transaction (26 U.S.C. 2057 (Supp. IV 1986), any short-term market losses or transaction costs incurred would be matters of relatively little concern. A

intend for estates to be able to claim the deduction by virtue of purchasing stock in the market and simply reselling the stock to an ESOP" 133 Cong. Rec. 4294 (1987) (Sen. Bentsen)).[14] It would have been extraordinary for Congress to provide a deduction for such "essentially sham transactions" (*ibid.).* It was therefore necessary for Congress promptly and retroactively to correct the legislation that, on its face, permitted such patent abuse. As this Court has recognized, Congress may be "properly concerned" with the need for retroactivity to prevent abuse of its tax legislation. *Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.,* 467 U.S. at 730.[15]

The means Congress employed to correct the potential abuse of Section 2057 were rationally related to this purpose. By limiting the availability of the Section 2057 deduction to estates of decedents who owned the securi-

transaction designed to accomplish nothing "beyond a tax deduction" (*Knetsch* v. *United States,* 364 U.S. 361, 366 (1960)) lacks economic substance.

[14] As the House Committee report states, "[t]he provision would not have been adopted in its present form had the full extent of the revenue impact and the effect of the provision been recognized," and "it is now necessary to modify the provision to bring the revenue loss in line with the original estimate and Congressional intent" (H.R. Rep. No. 391, *supra,* at 1045).

[15] Congress is frequently required to make "retroactive revisions of the federal * * * revenue laws" (*Welch* v. *Henry,* 305 U.S. at 145). Such revisions are needed to correct prior drafting errors, to "impose[ ] taxes on subjects previously untaxed" and to "shift[ ] the burden of old taxes by changes in rates, exemptions and deductions" (*ibid.*). In preparing tax legislation, it is not always possible for Congress to foresee all possible applications of proposed statutory language. The possibility of drafting errors is far from negligible in a massive legislative undertaking such as the Tax Reform Act of 1986, a highly complex bill that made extensive revisions in the Internal Revenue Code.

ties at the time of death, the 1987 amendment rationally furthers the legislative purpose. Moreover, this amendment was made retroactive for "only that * * * period that Congress believed would be necessary to accomplish its purposes" (*Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.,* 467 U.S. at 731). By making the curative legislation retroactive for the three-month period (October 1986 to January 1987) that preceded proposal of the 1987 amendment, the statute provides a uniform rule for all estates to which the deduction is available. It did not deny the benefits of the deduction to any estate that made a sale of securities that the decedent owned at death. The retroactive (and prospective, see note 8, *supra*) amendment merely forestalls abusive use of the statute by any estate to generate deductions for tax motivated, "essentially sham transactions" of the type in which respondent engaged.[16]

II. THE THREE-PART DUE PROCESS FORMULA APPLIED BY THE COURT OF APPEALS LACKS A FOUNDATION IN THE CONSTITUTION

In concluding that respondent is constitutionally entitled to different tax treatment from that accorded taxpayers engaging in similar transactions after Janu-

[16] In holding that the amendment to Section 2057 was unconstitutional as applied to respondent's purchase and sale of employer securities, the court of appeals lost sight of "the importance of reasonable opportunity for the legislative body, in the revision of the tax laws, to distribute increased costs of government among its taxpayers in the light of present need for revenue." *Welch* v. *Henry,* 305 U.S. at 149. Curative legislation designed to staunch an unintended loss of revenue by "conform[ing] the statute to the original intent of Congress" (133 Cong. Rec. 4145 (1987) (statement of Rep. Rostenkowski)) represents a rational means of accomplishing the legitimate legislative purpose.

ary 1987, the decision of the court of appeals is virtually the only modern case to strike down a retroactive amendment to an existing tax on due process grounds. As Judge Norris noted in dissent, "[t]he majority's opinion substitutes a test much more sympathetic to the taxpayer than those that courts have used in the past" (Pet. App. at 31a).

The three-step due process test adopted by the court of appeals for retroactive tax legislation looks to (i) whether the taxpayer had "actual or constructive notice that the tax statute would be retroactively amended" (Pet. App. 17a), (ii) whether the taxpayer relied "to his detriment on the pre-amendment tax statute" (*ibid.*), and (iii) whether such reliance was "reasonable" (*ibid.*). For the reasons we have already set forth, this three-part test (which would import common-law concepts of promissory estoppel into the Due Process Clause) lacks any basis in the Constitution or the decisions of this Court.

1. Every taxpayer is deemed to be aware of, and thus have "constructive notice" of, the possibility of changes in the provisions of existing tax laws. Changes in the rates of tax, the amounts of exemptions and the availability of deductions and credits play a continuing role in the evolving process of defraying and apportioning the cost of government. "Nobody has a vested right in the rate of taxation." *Cohan* v. *Commissioner*, 39 F.2d 540, 545 (2d Cir. 1930) (L. Hand, J.). The tax "system being already in operation," the taxpayer "must be prepared for such possibilities." *Ibid.* Congress is frequently called upon to make "retroactive revisions of the federal * * * revenue laws" and, in doing so, "impose[ ] taxes on subjects previously untaxed and shift[ ] the burden of old taxes by changes in rates, exemptions and deductions" (*Welch* v. *Henry*, 305 U.S. at 145). Every taxpayer

"should be regarded as taking his chances of any increase in the tax burden which might result from carrying out the established policy of taxation." *Milliken* v. *United States*, 283 U.S. at 23 (rejecting due process challenge to retroactive change in tax rate for certain gifts made prior to amendment). Because "no citizen enjoys immunity from that burden" (*Welch* v. *Henry*, 305 U.S. at 147), taxpayers can not "justly assert surprise or complain of arbitrary action" when Congress retroactively adjusts prior tax legislation in light of experience "at the first opportunity after knowledge of the nature and amount of the income is available." *Id.* at 150.[17] See

[17] In *Welch* v. *Henry*, 305 U.S. at 147, the Court distinguished the *Nichols*, *Blodgett* and *Untermyer* decisions (see note 10, *supra*), which had held retroactive features of the first federal gift tax unconstitutional. As the Court stated in *United States* v. *Hemme*, 476 U.S. at 568, those decisions involved retroactive application of an entirely new type of tax; their "authority is of limited value in assessing the constitutionality of subsequent amendments that bring about certain changes in operation of the tax laws, rather than the creation of a wholly new tax." See also *Milliken* v. *United States*, 283 U.S. at 23. As noted by Judge Norris in his dissent below, "[c]ases decided since *Welch* have upheld retroactive taxes on a variety of economic transactions, sharply limiting the scope of the *Lochner*-era cases" (Pet. App. 28a).

Notwithstanding this Court's admonition concerning the limited relevance of *Nichols*, *Blodgett* and *Untermyer* to cases involving "changes in operation of the tax laws," the court of appeals in the present case relied extensively on those decisions "to elucidate the factors we must consider in our determination" (Pet. App. 11a). By contrast, the other courts of appeals have consistently followed this Court's lead and limited those decisions to cases involving a "wholly new tax." See, *e.g.*, *Estate of Ekins* v. *Commissioner*, 797 F.2d 481, 484 (7th Cir. 1986); *Fein* v. *United States*, 730 F.2d 1211, 1213-1214 (8th Cir.) ("the modern trend of decisions has uniformly been to limit" *Untermyer* to the "narrow situation" there involved), cert. denied, 469 U.S. 858 (1984); *Estate of Ceppi* v. *Commissioner*, 698 F.2d 17, 21 (1st Cir.) (col-

also *United States* v. *Hemme,* 476 U.S. at 568; *United States* v. *Darusmont,* 449 U.S. at 298.

The many decisions of this Court that uphold retroactive "changes in operation of the tax laws" (*United States* v. *Hemme,* 476 U.S. at 568) do not dwell upon whether the taxpayer had "actual or constructive notice" (Pet. App. 17a) of the impending change. In *Milliken* v. *United States,* for example, the donor made gifts of stock in December 1916, when there was no gift tax but the estate tax applied to gifts made in contemplation of death. In 1918, Congress increased the estate tax rate on such gifts and applied that rate to gifts made prior to the enactment of the rate change. The donor died in 1920. His estate conceded that the 1916 gifts were includable in the taxable estate but contended that the

lecting cases and concluding, in light of this Court's subsequent decisions, that "*Untermyer* at best remains good law only for the proposition that a wholly new gift tax cannot be applied retroactively"), cert. denied, 462 U.S. 1120 (1983); *Westwick* v. *Commissioner*, 636 F.2d 291, 292 (10th Cir. 1980) (limiting *Untermyer* to "wholly new types of taxes"); *Buttke* v. *Commissioner*, 625 F.2d 202, 203 (8th Cir. 1980) (per curiam) (*Untermyer* bars "retroactive application of [a] wholly new tax"), cert. denied, 450 U.S. 982 (1981); *Shanahan* v. *United States*, 447 F.2d 1082, 1083 (10th Cir. 1971) ("the force of *Untermyer* has been vitiated by *Milliken* v. *United States*"); *First National Bank in Dallas* v. *United States*, 420 F.2d 725, 730 n.8 (Ct. Cl.) ("it is not entirely clear, in light of the above and the ever-increasing role of taxation in every area of activity, that the same result would obtain in these early cases [referring to *Nichols* v. *Coolidge, Blodgett* v. *Holden*, and *Untermyer* v. *Anderson*] were they before the court today"), cert. denied, 398 U.S. 950 (1970); *Sidney* v. *Commissioner*, 273 F.2d 928, 932 (2d Cir. 1960) (Friendly, J.) ("If *Untermyer* remains authority at all, it is so only for the particular situation of a wholly new type of tax"). See also Hochman, *The Supreme Court and the Constitutionality of Retroactive Legislation*, 73 Harv. L. Rev. 692 (1960); Ballard, *Retroactive Federal Taxation*, 48 Harv. L. Rev. 592 (1935).

rate of tax could be no higher than that prevailing at the time the gifts were made. The Court held that taxing the gifts at the higher rate in effect at decedent's death did not violate due process (283 U.S. at 23):

> Not only was the decedent left in no uncertainty that the gift he was then making was subject to the provisions of the existing statute, but in view of its well understood purpose he should be regarded as taking his chances of any increase in the tax burden which might result from carrying out the established policy of taxation under which substitutes for testamentary gifts were classed and taxed with them.

Similarly, in *Welch* v. *Henry,* the taxpayer's income in 1933 consisted in large part of dividends paid by corporations doing a majority of their business in Wisconsin. At that time, such dividends were deductible in computing net taxable income for purposes of the Wisconsin income tax. In 1935, however, Wisconsin imposed a graduated tax on all dividends received in 1933 which, when received, had been deductible from gross income under the law then in force. The Court upheld the measure, noting that Congress frequently enacts income tax laws that "redistribute[ ] retroactively the tax burdens imposed by preexisting laws." 305 U.S. at 148. The Court emphasized "the importance of reasonable opportunity for the legislative body, in the revision of the tax laws, to distribute increased costs of government among its taxpayers in the light of present need for revenue" and that "[w]ithout that opportunity accommodation of the legislative purpose to the need may be seriously obstructed if not defeated." 305 U.S. at 149. See also *United States* v. *Hemme,* 476 U.S. at 568 (re-

jecting the taxpayer's contention that retroactive "changes in the operation of the tax laws" are unconstitutional).

Contrary to the decision of the court of appeals in this case, preliminary public notice is not a constitutional prerequisite for retroactive legislation. Many changes in proposed legislation are made in House or Senate Committees or during debate. Federal statutes often emerge from Conference Committee bearing only slight resemblance to the versions approved by either the House or Senate. By holding that a taxpayer must be placed specifically on notice of impending tax legislation for that statute to apply retroactively, the court of appeals has ignored this Court's consistent holding that taxpayers cannot "justly assert surprise or complain of arbitrary action" when Congress retroactively adjusts prior tax legislation in light of experience "at the first opportunity after knowledge of the nature and amount of the income is available." *Welch* v. *Henry*, 305 U.S. at 150. Even when there is no prior notice of the legislation, the Court has concluded that retroactive legislation satisfies the "substantive" requirements of due process because it represents a rational means of accomplishing the legislature's legitimate purpose. *E.g., General Motors Corp.* v. *Romein*, 112 S.Ct. at 1112; *Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 730, 733.

2. The court of appeals further erred in concluding that respondent's purported reliance on the original terms of Section 2057 was "reasonable" (Pet. App. 23a). A taxpayer cannot "reasonably" rely on the assumption that Congress will not retroactively cure its prior drafting errors. As this Court has held, retroactive amendments of tax legislation are not unreasonable merely

because they may upset "otherwise settled expectations." *Usery* v. *Turner Elkhorn Mining Co.*, 428 U.S. at 16. Such retroactive legislation has often been enacted and often been upheld. *United States* v. *Darusmont*, 449 U.S. at 298 (quoting *Welch* v. *Henry*, 305 U.S. at 146-147).[18] A taxpayer therefore cannot "justly assert surprise" when, as here, Congress retroactively cures an error in prior legislation "at the first opportunity" (*Welch* v. *Henry*, 305 U.S. at 150).

"Taxation is neither a penalty imposed on the taxpayer nor a liability which he assumes by contract. It is but a way of apportioning the cost of government among those who in some measure are privileged to enjoy its benefits." *Welch* v. *Henry*, 305 U.S. at 146. Since "[n]obody has a vested right in the rate of taxation" (*Cohan* v. *Commissioner*, 39 F.2d at 545) (L. Hand, J.), a taxpayer cannot "reasonably" assume that an error or flaw in the formulation of tax legislation will not be corrected. See *Graham & Foster* v. *Goodcell*, 282 U.S. at 428.

That conclusion is especially appropriate when, as here, the statute on which the taxpayer purportedly

[18] This issue has arisen in many contexts. For example, a taxpayer's election to take advantage of a special benefit does not deprive Congress of the power to modify or withdraw the benefits of that election that would otherwise accrue in future taxable years. See, *e.g.*, *Lawler* v. *Commissioner*, 78 F.2d 567 (9th Cir. 1935) (upholding a statute revoking the installment method of reporting gain at the death of a taxpayer, even in the case of taxpayers who had previously elected to use the method). Deductions, credits and other tax benefits afforded under the Internal Revenue Code are privileges that may be revoked by Congress, not vested rights. See, *e.g.*, *Shanahan* v. *United States*, 447 F.2d at 1083; *Estate of Papson* v. *Commissioner*, 81 T.C. 105, 110 (1983); *Rose* v. *Commissioner*, 55 T.C. 28 (1970).

relied "on its face offered a benefit that appeared 'too good to be true' " (Pet. App. 34a) (Norris, J., dissenting). The amendment that Congress enacted to Section 2057 can scarcely have constituted a surprise to any thoughtful reader of the initial legislation. It was originally contemplated by Congress that the deduction "would be utilized in a limited number of transactions with a relatively modest revenue loss" (H.R. Rep. No. 391, Pt. II, *supra,* at 1045). If, as respondent contends, the original phrasing of the statute would have permitted every executor in the United States to negate the estate tax liability by the simple act of purchasing and reselling corporate securities, the fiscal impact of the legislation would obviously have differed greatly from Congress's original expectation.

Moreover, interpreting Section 2057 to permit a tax deduction for respondent's purchase and immediate resale of securities would flatly conflict with the well-established principle that purely tax-motivated transactions are not to be recognized for tax purposes. See, *e.g., Knetsch* v. *United States,* 364 U.S. at 366; *Gregory* v. *Helvering,* 293 U.S. 465, 470 (1935). As Senator Bentsen stated on the Senate floor in introducing the amendment, Congress did not intend to make the Section 2057 deduction available for "essentially sham transactions" (133 Cong. Rec. 4294 (1987)) and "did not intend for estates to be able to claim the deduction by virtue of purchasing stock in the market and simply reselling the stock to an ESOP" (*ibid.*). Against this background, the court of appeals plainly erred in stating that respondent "had little reason to think Congress had made a drafting error" (Pet. App. 21a).

It did not require the sophisticated executor of a large estate to recognize that "the statute on its face offered a

benefit that appeared 'too good to be true' " (Pet. App. 34a) (Norris, J., dissenting). In amending the statute to make clear that it is not designed to provide a tax windfall "for essentially sham transactions," Congress did no more than confirm the ordinary understanding of the proper limits of the legislation.[19]

---

[19] In concluding that the Section 2057 deduction "was enacted to induce taxpayers to sell shares at a discounted price to an ESOP" (Pet. App. 19a), the court of appeals misconstrued the purpose of the legislation. Section 2057 was enacted as an "incentive for stockholders to sell their companies to their employees who helped them build the company rather than liquidate, sell to outsiders or have the corporation redeem their shares on behalf of existing shareholders." Staff of the Joint Comm. on Taxation, 99th Cong., 2d Sess., *Tax Reform Proposals: Tax Treatment of Employee Stock Ownership Plans (ESOPs)* 37 (Comm. Print 1985); see also 132 Cong. Rec. 14,507 (1986) (statement of Sen. Long). Section 2057 was designed to encourage stockholders who had built their companies to sell *their* shares to ESOPs, thereby making available to ESOPs a pool of stock that otherwise might never have been made available—not merely to encourage ESOPs to buy more shares from the public, or to make those shares available at a discount. As Judge Norris aptly noted (Pet. App. 35a), "Congress could more providently have underwritten ESOP stock purchases directly from the U.S. Treasury without bringing in estate executors as middlemen!"

For example, in this case respondent asserts that the estate sold the shares to the ESOP at a discount of "26 cents per share" (Br. in Opp. 3). That assertion is debatable since respondent acknowledges (*ibid.*) that the lowest market price for the stock on that day was only 7.5 cents per share above the price at which respondent sold the stock to the ESOP. But, even if the discount were assumed to have been 26 cents per share, that discount would represent a total savings of only $390,000 for the 1,500,000 shares purchased by the ESOP. By comparison, the claimed estate tax deduction under Section 2057—of 50% of the total sale price of $10,575,000—would produce a tax benefit for the estate of more than $2,500,000 (Pet. App. 7a). If the Treasury had simply sent the ESOP a check for $390,000, the United States would have been more than $2 million better off than by providing the estate a deduction for this purely tax-motivated transaction.

3. Finally, the court of appeals' concern over respondent's alleged "detrimental reliance" on the original version of Section 2057 lacks both a legal and a factual foundation. The court concluded that the estate had relied on the statute to its detriment by engaging in a purchase and sale of MCI stock that resulted in a loss to the estate of $631,000. See note 6, *supra*. But, whether the estate makes a profit or a loss on its purchase and sale of stock is legally irrelevant to the availability of the Section 2057 deduction: the deduction is calculated simply as one-half of the gross proceeds received from the sale. See 26 U.S.C. 2057(a) (Supp. IV 1986).

Moreover, in this case (as in almost any case involving publicly-traded stock), respondent could have made a profit as easily as a loss on the estate's transaction. While the court of appeals emphasized repeatedly that the "estate was out $631,000" on its transaction in MCI stock (Pet. App. 23a), if respondent had purchased the MCI stock only a few days earlier, the sale would have netted the estate a sizeable profit instead of a loss. See note 6, *supra*. In either situation, the amount of the claimed deduction under Section 2057 would be the same. See note 6, *supra*.[20]

The necessary implication of the court's rationale is that the constitutionality of the amending legislation turns on whether respondent timed his purchases of

[20] Moreover, but for the fact that respondent was granted an extension to December 1986 of the time to file the estate tax return, the return would have been due in June 1986, before Section 2057 was enacted. See page 2, *supra*. When enacted, Section 2057 was made applicable only to estates for which returns had not then been filed. See page 3, *supra*. The estate cannot be said to have suffered any detriment from the denial of a deduction for which, but for the grant of a discretionary extension, it would not have been eligible in the first place.

MCI stock well or poorly. There is no precedent for such wavering constitutional guidelines for the validity of retroactive legislation.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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No. 92-1941

In The

Supreme Court of the United States

October Term, 1993

UNITED STATES OF AMERICA,

Petitioner,

v.

JERRY W. CARLTON, EXECUTOR OF THE WILL OF WILLAMETTA K. DAY,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF FOR RESPONDENT

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QUESTION PRESENTED

Can the government enact a new estate tax deduction to induce executors to sell estate assets at a discount to an employee stock ownership plan and, after a taxpayer has done so, deprive the taxpayer of the benefit of the deduction by imposing unforeseeable conditions retroactively?

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BRIEF FOR RESPONDENT

STATEMENT OF THE CASE

In 1984, the Senate proposed an estate tax deduction for one-half of the proceeds of an executor's sale of a company's stock to its employee stock ownership plan ("ESOP") completed before the deadline for filing the federal estate tax return (including any extension). (Br. in Opp. App. 49a.)[1] Although not enacted in 1984, Congress

[1] Following the convention of the Brief on the Merits of the United States, respondent cites the Stipulation and Order of Uncontroverted Facts and Narrowing Potential Issues in Controversy by reference to Appendix E of respondent's Brief in

enacted a similar provision that became effective October 22, 1986. Tax Reform Act of 1986, Pub. L. No. 99-514 (the "TRA"), § 1172, 100 Stat. 2085, 2513-15 (codified at 26 U.S.C. § 2057) (amended 1987; repealed 1989).[2]

Between the time it passed the TRA and its adjournment, the 99th Congress considered a large number of potential "corrections" to the TRA and made several changes to it. No bill or resolution was introduced, however, that would have added any additional condition to the availability of the new estate tax deduction to those contained in the statute itself. (Br. in Opp. App. 48a-49a.)

Willametta K. Day ("Mrs. Day") had died on September 29, 1985. Taking into account a six-month extension, the federal estate tax return for her estate was due on December 29, 1986. As executor of Mrs. Day's will, Jerry W. Carlton ("the executor") reviewed the provisions of the TRA, its amendments, and the possible amendments to it proposed before Congress adjourned and determined that it was in the estate's financial interest to avail itself of the new estate tax deduction. He then purchased 1,500,000 shares of MCI Communications Corporation ("MCI") stock on December 10, 1986 for an average price of $7.47 per share. Although he had determined that its ESOP might be interested in acquiring some MCI stock, the executor had no advance agreement to sell the stock

Opposition. A copy of the original appears as item 14 of the clerk's record from the District Court and under tab 3 of the Excerpts of Record in the Court of Appeals.

[2] Unless otherwise specified, section references are to the Internal Revenue Code of 1986 (26 U.S.C.) (Supp. IV 1986). The relevant portion of the 1986 legislation is quoted at note 1 of respondent's Brief in Opposition.

to the ESOP and, thus, bore the market risk of holding the stock for sale to the ESOP or on the open market. (Br. in Opp. App. 50a.)

On December 12, 1986, the trading price for MCI stock ranged from $7.125 to $7.50; the executor entered into an agreement to sell the stock to the ESOP for $7.05 per share. In accordance with Section 2057, the executor obtained MCI's agreement to the application of Section 4979A (amended 1989) to MCI (as required by Section 2057(d) (amended 1987; repealed 1989)) and obtained an opinion from MCI's general counsel that its ESOP was a plan described in Section 4975(e)(7) (amended 1990) (as required by Section 2057(b)(1) (amended 1987; repealed 1989)). On December 17, 1986, the sale was consummated. (Br. in Opp. App. 50a-51a.)

The government has conceded that the executor would *not* have purchased the stock at its then-prevailing price of $7.47 per share and sold it to the ESOP at a discounted $7.05 per-share price (and incurred incidental transaction costs) but for the Section 2057 deduction and that the ESOP would *not* have been able to purchase the stock at the discounted price if the executor had not expected to receive that deduction. (Br. in Opp. App. 51a.)

On December 29, 1986, the executor timely filed Mrs. Day's federal estate tax return, claiming a deduction for 50 percent of the proceeds of sale of the MCI stock and paying $18,752,250 in estate tax. (Br. in Opp. App. 51a.)

On January 5, 1987, the Internal Revenue Service (the "Service") announced that "[p]ending the enactment of *clarifying* legislation," it would *not* allow a Section 2057

deduction: (1) unless a decedent "directly owned" the securities before death and (2) unless the securities were allocated or held for future allocation *by the plan* in particular ways.[3] I.R.S. Notice 87-13, 1987-1 C.B. 432, 442 (emphasis added). The government has conceded that neither requirement was contained in the TRA and that neither was identified in the hundreds of technical and clerical amendments proposed before Congress adjourned. (Br. in Opp. App. 52a.)

On December 22, 1987, Congress enacted legislation imposing these two additional requirements retroactively to October 22, 1986 – as well as making a number of other changes effective for sales made after February 26, 1987, the date of introduction of the 1987 legislation. Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, §§ 10411, 10412, 101 Stat. 1330, 1330-432 to 1330-436 (codified at 26 U.S.C. § 2057 (Supp. V 1987) (repealed 1989)).

After the Service audited Mrs. Day's federal estate tax return, it disallowed the claimed ESOP proceeds deduction[4] and denied the executor's claim for refund after the executor paid the deficiency assessed. (Br. in Opp. App. 53a-54a.) The executor then instituted this refund action. The District Court held for petitioner, and

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[3] In general, the 1987 plan allocation rules (a) require that the ESOP immediately allocate the securities to participants' accounts or hold them for future allocation in accordance with rules that apply in other contexts and (b) preclude the ESOP from substituting the securities for other employer stock already held by the ESOP.

[4] The deficiency attributable to the ESOP proceeds deduction was $2,501,161. (Br. in Opp. App. 54a.)

the Ninth Circuit reversed and remanded with instructions to enter judgment for the executor (Norris, J., dissenting). *Carlton v. United States*, 972 F.2d 1051 (9th Cir. 1992). The Ninth Circuit denied a petition for rehearing and rejected a suggestion for rehearing en banc.

SUMMARY OF ARGUMENT

The Due Process Clause limits the Congress's Taxing Power by prohibiting the retroactive application of unduly harsh and oppressive changes. "In each case, it is necessary to consider the nature of the tax and the circumstances in which it is laid before it can be said [whether] its retroactive application is so harsh and oppressive as to transgress the constitutional limitation." *Welch v. Henry*, 305 U.S. 134, 147 (1938). *Accord United States v. Hemme*, 476 U.S. 558, 568-69 (1986).

Among numerous provisions included in the TRA to promote stock ownership through ESOPs, Congress enacted a new federal estate tax deduction to induce executors to sell stock to ESOPs at a discount below fair market value. Relying on the inducement of this deduction, Mrs. Day's executor purchased MCI stock in the open market and resold it to the MCI ESOP at a discount below fair market value. The transaction complied with all then-existing requirements of the statute. The executor filed the estate tax return, and paid the tax due. The government now seeks to deny the executor the deduction and impose an involuntary gift to the ESOP participants by adding, retroactively, two unforeseeable conditions on the deduction.

Retroactive application of the two unforeseeable conditions in this instance violates the Due Process limitation. It is singularly harsh and oppressive for Congress to use the inducement of a tax benefit to encourage private support of the public goal of promoting employee stock ownership and, subsequently, to deny a taxpayer the very benefit that induced the purchase and sale.

None of the cases cited by the Solicitor General involves government inducement of a transaction to accomplish a public goal with private funds. Moreover, most involve taxpayer action after a legislative change had been proposed. Finally, the justifications for the retroactive amendments postulated by the government do not support retroactive application in this instance.

ARGUMENT

I. DUE PROCESS LIMITS HARSH AND OPPRESSIVE RETROACTIVE TAXATION.

Due Process requires that the retroactive effect of tax legislation be supported by a legitimate legislative purpose furthered by rational means. *Pension Benefit Guar. Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 729 (1984). What satisfies this purpose and means test in the context of prospective legislation may not suffice for retroactive legislation. *Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1, 16-17 (1976).[5] Moreover, a tax statute may not be applied

[5] "[R]etroactive legislation does have to meet a burden not faced by legislation that has only future effects." *Pension Benefit Guar. Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 730 (1984). "Retroactive legislation presents problems of unfairness that are more serious than those posed by prospective legislation, because it can deprive citizens of legitimate expectations and upset settled transactions." *General Motors Corp. v. Romein*, 112 S. Ct. 1105, 1112 (1992).

retroactively if an unduly "harsh and oppressive" result arises from the "nature of the tax and the circumstances in which it is laid." *United States v. Hemme*, 476 U.S. 558, 568-69 (1986); *Welch v. Henry*, 305 U.S. 134, 147 (1938). By definition, retroactive legislation that is unduly harsh and oppressive in its application does not further its purpose by a rational means. Indeed, the "harsh and oppressive" standard is functionally equivalent to the "arbitrary and irrational" inquiry used to test the due process sufficiency of retroactive civil litigation in contexts outside the tax field. *See Gray*, 467 U.S. at 733.[6]

The "harsh and oppressive" test requires consideration of both the object of legislation and its effect upon the taxpayer. The inquiry is necessarily fact-based, looking to the nature, purpose and background of the legislation on the one hand, and to its effect on the taxpayer on the other. In considering the nature of the tax and the circumstances in which it is laid, the Court has been concerned with (1) whether taxation was reasonably foreseeable at the time of a transaction, (2) whether, if foreseen, the taxpayer might have avoided the tax, and (3) whether the taxpayer was injured by retroactive application of the change. In the context of reviewing retroactive changes of state law, the Court also has

[6] The Court sometimes has described the retroactive application of a revenue measure that transgressed the Due Process limit as "arbitrary and capricious." *See, e.g., Nichols v. Coolidge*, 274 U.S. 531, 542 (1927).

been concerned with protecting a citizen who has been induced by the government to devote private resources to pursue a public goal; the same concern is relevant in considering the circumstances of retroactive federal taxation.

The parameters of the "harsh and oppressive" test initially were developed from a series of earlier estate and gift tax cases in which the Due Process limit had been transgressed.[7] Writing in *Welch*, Justice Stone summarized the rationale of these cases as follows:

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[7] In *Nichols v. Coolidge*, 274 U.S. 531 (1927), the Court had prohibited the application of a provision of the 1919 estate tax statute taxing a transfer taking effect at death to two groups of assets in which Mrs. Coolidge had retained an interest for her life but in which she had transferred the successive interest before enactment. *Accord Helvering v. Helmholz*, 296 U.S. 93, 96-97 (1935) (alternative holding in which all justices concurred); *White v. Poor*, 296 U.S. 98, 102 (1935) (alternative holding). Mrs. Coolidge's transfers came back before the Court in *Coolidge v. Long*, 282 U.S. 582 (1931). Retroactive application of Massachusetts' inheritance tax also was a Due Process and Contract Clause violation. 282 U.S. at 595-96, 605-606.

In *Blodgett v. Holden*, 275 U.S. 142 (1927), the Court had found a Due Process constraint in the retroactive application of the first federal gift tax. In that case, four justices interpreted the statute to avoid the Constitutional question, while four others concluded that retroactive application was arbitrary and violated the Due Process Clause. "As to the gifts which Blodgett made during January, 1924 [before introduction on February 25 or enactment on June 2], we think the challenged enactment is arbitrary and for that reason invalid. It seems wholly unreasonable that one who, in entire good faith and without the slightest premonition of such consequence, made absolute disposition of his property by gifts should thereafter be required to pay a charge for so doing." 275 U.S. at 147 (McReynolds, J.). *See Untermyer v. Anderson*, 276 U.S. 440 (1928) (in which the majority followed Justice McReynolds' opinion in *Blodgett*).

> In the cases in which this Court has held invalid the taxation of gifts made and completely vested before the enactment of the taxing statute, decision was rested on the ground that the nature or amount of the tax could not reasonably have been anticipated by the taxpayer at the time of the particular voluntary act which the statute later made the taxable event. . . . Since, in each of these cases, the donor might freely have chosen to give or not to give, the taxation, after the choice was made, of a gift which he might well have refrained from making had he anticipated the tax, was thought to be so arbitrary and oppressive as to be a denial of due process.

305 U.S. at 147 (citations omitted).[8]

The Court identified another circumstance relevant in determining whether retroactive taxation was unduly "harsh and oppressive" in *Hemme*: "One of the relevant circumstances is whether . . . a statute gives a different and more oppressive legal effect to conduct undertaken before enactment of the statute." 476 U.S. at 569.[9]

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[8] In an article cited by the Solicitor General, Professor Hochman concluded: "The primary consideration which appears from an analysis of the cases involving retroactive taxation is the ability of the taxpayer, at the time of the transaction in dispute, reasonably to have foreseen that a tax would be imposed, and the likelihood that, having been able to foresee it, he would have altered his conduct to avoid the tax." Charles B. Hochman, *The Supreme Court and the Constitutionality of Retroactive Legislation*, 73 Harv. L. Rev. 692, 706 (1960) (footnote omitted).

[9] Justice Thurgood Marshall described the foreseeability consideration as whether the taxpayer had "notice" of the

An additional concern, and one that sets this case apart, is whether the retroactive change deprives a citizen of a benefit that the government used to induce that citizen to behave in a particular way and in which he or she would not have behaved but for the benefit. Such a change is especially harsh and oppressive. The historic roots of this consideration lie in early cases reviewing retroactive state legislation.[10]

For example, in *New Jersey v. Wilson*, 11 U.S. (7 Cranch) 164 (1812), the Marshall Court rejected New Jersey's attempt to rescind (prospectively) a property tax exemption for formerly Indian-owned land that had been enacted to induce the Indians to release their claim to other New Jersey land. (Presumably, the purchasers of the land also took the tax exemption into consideration in determining the price).[11]

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change in the law. *Hemme*, 476 U.S. at 569 (1986); *cf. Gray*, 467 U.S. at 733; *United States v. Darusmont*, 449 U.S. 292, 299 (1981) (per curiam).

[10] Professor Tribe refers to "a simple constitutional principle," that when it induces reliance, *"government must keep its word."* Laurence H. Tribe, *American Constitutional Law* 619 (2d ed. 1988) (discussing limitations on state government action) (footnote omitted) (emphasis added).

[11] *Cf. Fletcher v. Peck*, 10 U.S. (6 Cranch) 87 (1810) (attempted rescission of scandal-tainted land grants where Fletcher purchased Georgia land relying on title traceable to 1795 grants); *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518 (1819) (after donors had financed the college in reliance on the terms of its perpetual charter from the Crown, New Hampshire's "hostile takeover" by changing the charter and "packing" the board of trustees was unconstitutional).

Early Marshall Court decisions were followed throughout the 19th Century in both state-granted monopoly[12] and tax exemption cases. In *Wilmington Railroad v. Reid*, 80 U.S. (13 Wall.) 264 (1872), North Carolina's withdrawal of a tax benefit was overturned:

> The General Assembly of North Carolina told the Wilmington and Weldon Railroad Company, *in language which no one can misunderstand*, that if they would complete the work of internal improvement for which they were incorporated, their property and the shares of their stockholders should be forever exempt from taxation.

80 U.S. at 267 (emphasis added). *Accord Humphrey v. Pegues*, 83 U.S. (16 Wall.) 244 (1873); *Pacific R.R. v. Maguire*, 87 U.S. (20 Wall.) 36 (1874).

By the early 20th Century, the basis for reviewing retroactive state legislation had shifted largely from the Contract Clause to the Due Process Clause of the Fourteenth Amendment.[13] In *Forbes Pioneer Boat Line v. Board of Commissioners*, 258 U.S. 338 (1922), Justice Holmes stated:

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[12] *E.g., The Binghamton Bridge*, 70 U.S. (3 Wall.) 51 (1866) (New York could not authorize a new bridge to compete with one built earlier in the century under a charter granting an exclusive franchise).

[13] Alexander M. Bickel & Benno C. Schmidt, Jr., *The Judiciary and Responsible Government 1910-21* 300 (The Oliver Wendall Holmes Devise History of the Supreme Court of the United States Vol. IX, 1984).

> Stripped of conciliatory phrases the question is whether a state legislature can take away from a private party a right to recover money [a tax refund] that is due when the act is passed.

258 U.S. at 339. That case arose out of the 1913-1917 unauthorized collection of tolls for passing through a lock installed in an Everglades drainage canal in 1913. Summarizing the case, Justice Holmes said:

> Defendant [the toll collector] owed the plaintiff [a canal user] a definite sum of money that it had extorted from the plaintiff without right. . . . To say that the Legislature simply was establishing the situation as both parties knew from the beginning it ought to be [by purportedly retroactive legislation authorizing toll collection] would be putting something of a gloss upon the facts. We must assume that the *plaintiff went through the canal relying upon its legal rights and it is not to be deprived of them because the Legislature forgot*.

258 U.S. at 340 (emphasis added).[14]

Application of the *Welch* "harsh and oppressive" limit on retroactive taxation in the circumstances of this case prohibits restriction of the Section 2057 estate tax deduction by the decedent ownership and plan allocation requirements because: (1) the executor had no notice, actual or constructive, that Congress would renege on the deduction; (2) the executor acted in complete reliance on the availability of the deduction and would not otherwise

[14] *See generally Ettor v. City of Tacoma*, 228 U.S. 148 (1913) (Washington legislature's retroactive attempt to deprive a landowner of consequential damages).

have engaged in the transaction; (3) the executor was injured by making the sale below market; and (4) unlike any other prior challenge to retroactive federal tax legislation, the statute *specifically induced* the executor to act to his detriment in furtherance of employee stock ownership in language that no one can misunderstand.[15] He cannot be deprived of the benefit of the deduction, even if this Court were to conclude that the Legislature forgot to include the two subsequently imposed conditions.

[15] The Solicitor General attempts to confine the holding of the estate and gift tax cases that have invalidated retroactive taxes on Due Process grounds to instances of "wholly new taxes." (Br. for U.S. 21 n.17.) As the Court of Appeals recognized, that view is overly narrow; the Court's detailed review of the circumstances in *Hemme* and *United States v. Darusmont*, 449 U.S. 292 (1981) (per curiam), would have been unnecessary if there were a *per se* rule that the Due Process limit is relevant to only a "wholly new" tax. *Carlton*, 972 U.S. at 1056. Justice Stone's and Professor Hochman's synopses illustrate that retroactive application of the new taxes in the old estate and gift tax cases was unduly "harsh and oppressive" because it was unforeseeable and prevented the taxpayers from planning their estates to reduce or avoid the taxes. See *supra* note 8 and accompanying text. The factors of foreseeability and reliance are even more compelling here. There could hardly be a circumstance less foreseeable to a taxpayer than for his government to induce him to devote his resources to support a public goal and, then, after he has done so, to rescind the deduction that provided the inducement. Even assuming foreseeability and reliance were not, by themselves, sufficient reasons to invalidate the retroactive application of a tax, there can be little question that the line defining "harsh and oppressive" application is crossed where the taxpayer's conduct has been induced as well.

II. IN THE CIRCUMSTANCES OF THIS CASE, THE DUE PROCESS LIMITATION WAS EXCEEDED BY THE RETROACTIVE RESTRICTIONS ON THE SECTION 2057 DEDUCTION.

As discussed in detail below, the retroactive changes to Section 2057 were not foreseeable by the executor in December 1986. There can be no dispute about the other three considerations identified in Section I for determining whether retroactive taxation is unduly harsh and oppressive. Not only *might* the executor have changed his conduct if he had foreseen the change, the government has stipulated that the executor *would* have changed his behavior. (Br. in Opp. App. 51a.) Similarly, the government has stipulated that the executor was injured by the transaction. (*Id.* at 50a-51a.) Finally, the government has stipulated that the executor's behavior was induced by the benefit of the Section 2057 deduction: (1) He would not have sold the MCI stock to the ESOP at a below-market price (and incurred incidental transaction costs) if he had not expected the Section 2057 deduction (Br. in Opp. App. 51a), and (2) he was entitled to the deduction as the statute then existed (*id.* at 54a). Indeed, there was no conceivable reason for *any* executor to sell *any* stock to an ESOP at a below-market price other than to obtain the expected tax benefit.

A. In the Context of the Extraordinary Tax Benefits that Congress Has Used to Promote ESOPs, Section 2057 Was Neither Unusual Nor Surprising.

The new 1986 estate tax deduction was a part of the nation's long-standing policy of providing extraordinary encouragement for the growth of ESOPs through tax benefits.[16] As summarized by the General Accounting Office in late 1986:

> The major purposes of [ESOPs] are to broaden the ownership of stock, to provide a mechanism for financing capital growth and the transfer of stock ownership to employees, and to promote improvements in productivity and profitability in sponsoring firms. These goals are based on the belief that the concentration of stock ownership, the dependence of firms on internal sources of funds for corporate finance, and the slow growth of productivity in the U.S. are serious and related problems that can be addressed by making employees owners of stock in the firms that employ them.

Employee Stock Ownership Plans: Benefits and Costs of ESOP Tax Incentives for Broadening Stock Ownership (GAO/PEMD 87-88) 4 (1986). In the context of the wide variety and scope of ESOP deductions, credits and exclusions that Congress had

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[16] *See generally* Staff of Joint Committee on Taxation, 99th Cong., 1st Sess., *Tax Reform Proposals: Tax Treatment of Employee Stock Ownership Plans (ESOPs)* 2-14 (Comm. Print 42-85 1985) (the "1985 Joint Committee Study"); *see also* 132 Cong. Rec. 14507, 14512-13 (1986) (statement of Sen. Long).

The most basic tax benefit for ESOPs (and one applicable to other retirement plans) is tax deferral. The tax law provides an incentive for an employer to fund a stock bonus plan that makes employees part owners of the business by allowing the employer an immediate corporate income tax deduction while deferring any income tax consequence to each employee until the plan makes a distribution to the employee. 26 U.S.C. §§ 402(a), 404(a) (Supp. IV 1992). In effect, the government makes an interest-free loan equal to the income tax otherwise payable either by the employer or the employee that is repaid when the ESOP makes distributions to its employee-participants.

employed over the years, the executor had no reason to anticipate the imposition of a decedent ownership or plan allocation condition to restrict the scope of Section 2057.

Virtually every major tax bill from 1974 until Senator Russell B. Long's retirement at the end of 1986 contained ESOP tax subsidies. These began with the Employee Retirement Income Security Act of 1974 ("ERISA"), which included a substantial number of provisions unique to ESOPs,[17]

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[17] Under ERISA, ESOPs are exempt from the general requirement that no more than 10% of a retirement plan's assets can be invested in the stock of the employer, 29 U.S.C. §§ 1104(a)(2), 1107(b)(1), 1107(d)(3) (Supp. IV 1986), and an employer's sale of stock to its ESOP is exempt from the generally applicable prohibited transaction rules, 29 U.S.C. § 1108(e) (Supp. IV 1986); Section 4975(d)(13) (amended 1990).

An employer also is allowed to make loans and guarantee third-party loans to its ESOP that are used to purchase employer stock – which dramatically increases the amount of stock an ESOP can purchase. 29 U.S.C. § 1108(b)(3) (1982); 26 U.S.C. § 4975(d)(3) (1982). These provisions for "leveraged" ESOP stock purchases make ESOP funding a major tool of corporate finance. Repayment of ESOP loans is financed through fully deductible employer contributions – effectively allowing the employer to finance both principal and interest of the loans with pre-tax corporate income. Section 404(a)(9). As a corporate finance device, the potential tax benefit is almost unlimited; the deduction for repayment of principal is limited only by 25% of the participants' *entire* payroll (principal payments allocable to any single plan participant may be as high as $30,000), and the deduction for payment of interest is unlimited. Sections 404(a)(9)(A)-(B), 415(c)(1), 415(c)(6)(B). (Instead of borrowing directly or selling stock to others to finance business activities (in which case it would have to make principal or dividend payments with after-tax cash flow), the sponsoring employer sells stock to its ESOP, guarantees repayment of the ESOP's debt to a lender, and funds the ESOP's entire debt service with pre-tax contributions (in which case principal payments are made with pre-tax cash flow).

and continued in the Tax Reduction Act of 1975,[18] the Tax Reform Act of 1976,[19] the Economic Recovery Tax Act of 1981,[20] the Deficit Reduction Act of 1984,[21] and the

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The employees become stockholders, and the employer's cost of funds drops significantly.)

[18] Until superseded by the Economic Recovery Tax Act of 1981 ("ERTA"), a corporate employer was entitled to a 1% addition to its 10% investment tax credit for an equivalent contribution to its ESOP. (The government paid 100% of the ESOP contribution.) 26 U.S.C. § 46(a)(1)(B) (Supp. V 1975) (repealed 1981).

[19] Until superseded by ERTA, a corporate employer was allowed an *additional* 1/2% investment tax credit for a contribution matched by employees. 26 U.S.C. § 46(a)(2)(B)(ii) (1976) (repealed 1981). As a result of the Tax Reform Act of 1976 ("TRA 76"), ESOPs enjoy an exception to the general prohibition against any distribution of funds to an employee until retirement, disability or separation for employer dividends passed through to the participants. 26 C.F.R. § 54.4975-11(f)(3) (1979). Those dividends can, in turn, be used to finance the employee contributions. *See generally* TRA 76, § 803(h), 90 Stat. 1520, 1590.

[20] ERTA replaced the additions to the investment tax credit described *supra* notes 18 and 19 with a tax credit of up to 1/2% of total participant payroll. 26 U.S.C. § 41(a)(2) (Supp. IV 1981) (repealed 1986). (The government was still bearing the cost dollar-for-dollar, but the "base" was shifted from investment in capital equipment to the payroll of the employees who are participants in the ESOP.) While 1/2% is a small percentage, total payroll costs provide an extraordinarily large "base" for determining the amount of the government subsidy.

[21] The Deficit Reduction Act of 1984 ("DEFRA") augmented the provisions described *supra* note 19 by allowing a corporate income tax deduction for dividends paid to an ESOP that are passed through to participants. 26 U.S.C. § 404(k)(2)(A)-(B) (Supp. II 1984). (This eliminated the generally applicable "double tax" (once at the corporate level and once at the plan participant level) on a part of the corporation's earnings.)

TRA.[22] While most of these exotic provisions provide tax incentives to employers that fund ESOPs, Section 133

Moreover, DEFRA provides an income tax *exclusion* for banks of one-half of interest income (in an unlimited amount) from ESOP loans. Section 133.

DEFRA also permits persons who sell stock in a closely held company to its ESOP to defer tax on an unlimited amount of long-term capital gain by reinvesting the proceeds of sale in other securities. Section 1042. (This allows a taxpayer with substantial appreciation in closely held stock to diversify, defer gain recognition, and still have the potential of completely avoiding gain recognition if the replacement securities are held until death. Section 1014.)

Lastly, until repealed in 1989, DEFRA permitted an ESOP to assume the estate tax obligation attributable to stock in the sponsoring employer for a shareholder who sold the stock to the ESOP, provided the employer guaranteed the payment of tax. Section 2210 (repealed 1989). (This provision allowed the corporation to pay an unlimited amount of estate tax with pre-income tax dollars, rather than requiring the shareholder to pay the tax with the much smaller net proceeds of corporate income after it had been taxed first at the corporate level and then (as a dividend) at the shareholder level.)

[22] The TRA repealed the tax credit funding of ESOPs with a direct dollar-for-dollar tax subsidy, but added a corporate income tax deduction for dividends paid on stock held by an ESOP when those dividends are applied to the repayment of a loan used to acquire employer securities. Section 404(k)(2)(C) (now codified at 26 U.S.C. § 404(k)(2)(A)(ii) (Supp. I 1989)). (By eliminating the corporate-level tax on income used to finance ESOP stock purchases (as well as deferring the tax at the participant level), this provision further encourages a corporate employer to "leverage" its ESOP contribution by guaranteeing repayment of a loan to the ESOP while providing the funds to service the debt out of pre-tax corporate income.)

The TRA extended the unlimited 50% interest income exclusion of DEFRA described *supra* note 21 to regulated investment companies, as well as banks. Section 133(a)(4).

encourages banks and regulated investment companies to assist in the funding of ESOPs with interest rate discounts and Section 1042 encourages shareholders to assist with price discounts when selling employer securities to its ESOP (as did Section 2210 before its 1989 repeal). The tax law leaves to negotiations in the marketplace the allocation of the expected tax benefit between the "outsider" and the ESOP.[23]

Finally, the TRA enacted the new estate tax deduction that is the focus of this litigation.

[23] The Solicitor General's argument that the executor's loss on the sale is not relevant to the deduction, and that he could as easily have made a profit on the transaction (Br. for U.S. 4 n.6, 28), misses the point. Although gain or loss when compared with income tax basis is irrelevant, sale below market price is the *sine qua non* of the deduction; without a discount, an ESOP simply would buy stock in the open market, and the executor would get no deduction. A sale above income tax basis but below fair market value is just as much a bargain sale as one below income tax basis.

Like Section 2057, Section 2210 (repealed 1989) did not explicitly require a discount price when the ESOP assumed estate tax liability in connection with a purchase of stock from an executor; Section 1042 does not explicitly require a discount for a shareholder to defer gain on an ESOP sale; and, Section 133 does not require a discount interest rate for banks to exclude one-half of the interest income from an ESOP loan from income. Instead, Congress gave the ESOP bargaining power to obtain a portion of the tax benefit available to the seller or lender; an ESOP will participate in any particular tax-induced transaction *only* at a discount (because of the existence of other potential sellers or lenders and the ability to buy or borrow at market rates from others without any restriction on the ESOP after the purchase or borrowing). In each case the market determines the allocation of the tax benefit between the ESOP and the "third party." The Court of Appeals recognized this economic fact of

In this legislative context, the provisions of the new estate tax deduction were neither unusual nor surprising.

B. Nothing in Section 2057 or its Legislative History Presaged the Retroactive Restrictions.

Contrary to petitioner's implication (Br. for U.S. 24), Section 2057 was not a last-minute addition in Conference Committee. Language similar to that enacted as part of the TRA was proposed by the Senate in 1984 as part of the Deficit Reduction Act of 1984, S. Rep. No. 169, 98th Cong., 2d Sess., vol. I, at 335, vol. II, at 338-40, but was deleted in the Conference Committee deliberations in 1984, H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1181-84. In 1985, the deduction was included in a study of ESOP proposals. 1985 Joint Committee Study 20, 37.[24] In

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life, *Carlton*, 972 F.2d at 1061, and, indeed, the government has stipulated that the executor would not have sold and the ESOP would not have been able to purchase the stock at a discount if the executor had not anticipated the Section 2057 deduction. (Br. in Opp. App. 51a.)

[24] The 1985 Joint Committee Study contains a relatively detailed review of then-existing law (with particular attention to incentives for ESOP financing), the Reagan Administration's May 1985 proposal for changes relating to ESOPs, other proposals that had been advanced, and an analysis of those various proposals. One proposal discussed briefly, *id.* at 20, 37, was the Senate Finance Committee's 1984 proposal for an estate tax "exclusion." As drafted in 1984, it would have allowed an estate tax deduction for one-half of the sales proceeds for sales completed by a stockholder during lifetime or by an executor at any time before the federal estate tax return was due (including extensions). The 1985 Joint Committee Study noted several objections to allowing a deduction for lifetime sales and certain

the spring of 1986, the Senate added Section 2057 to its version of the TRA. S. Rep. No. 313, 99th Cong., 2d Sess., pt. 1, at 681-82, pt. 2, at 2175-78. Except for adding a five-year "sunset" provision, the House acceded in the Conference Committee. H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess., pt. I at 453-54, pt. II at 560 (1986).

As enacted (and when the 99th Congress adjourned), the statute was clear on its face. Indeed, the government has stipulated that: (1) neither the decedent ownership nor the plan allocation requirement was contained in Section 2057 as initially enacted (Br. in Opp. App. 52a); (2) neither was contained in any amendment to the statute before the executor made his below-market sale to the ESOP, filed his estate tax return, and paid his tax (*id.*); (3) neither was contained in any of the hundreds of potential technical and clerical amendments to the statute considered before the Congress adjourned (*id.* at 48a-49a, 52a); and (4) "[n]o bill or resolution was introduced that would have added any condition to the availability of the new [s]ection 2057 deduction other than those contained in the statute itself during the period between the passage of

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other objections to the 1984 Senate provision. Singularly absent from the discussion is any suggestion of an ownership requirement – either for a particular period of time (like the 12-month holding period then required for deferral of gain on a stockholder's sale to an ESOP under Section 1042(b)(4), 1985 Joint Committee Study at 14), or during a decedent's lifetime (as was required for an ESOP's assumption of estate tax liability under Section 2210(b)(2)(A) (repealed 1989)). Also absent is any discussion of a plan allocation rule like that now sought to be imposed retroactively.

the [1986 legislation] and the adjournment [of the 99th Congress] on October 18, 1986" (*id.* at 49a).[25]

Petitioner contends that the more obscure history of the 1986 legislation should have forewarned the executor that a deduction would not be available to him, because Mrs. Day had not owned the MCI stock before her death. (Br. for U.S. 5 n.7, 27 n.19.) As did the Court of Appeals, this Court should "flatly reject the government's premise that a taxpayer cannot rely on the clear and unequivocal text of the tax code, but instead must speculate on the unspoken and inchoate intentions of Congress." *Carlton*, 972 F.2d at 1060.[26] Assuming, *arguendo*, that the executor

[25] In view of the hundreds of proposed amendments to the TRA considered before the 99th Congress adjourned (one of which dealt specifically with Section 2057) and the TRA changes enacted by the Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, 100 Stat. 1874 (Br. in Opp. App. 48a-49a), Congress did not act to amend Section 2057 "at the first opportunity," as petitioner contends (Br. for U.S. 24-25).

[26] Because the language of Section 2057 was clear, there was no more reason for the executor to consult the legislative history than there would be for a court to do so in interpreting the statute. *Cf. Toibb v. Radloff*, 111 S. Ct. 2197, 2200 (1991) ("although a court appropriately may refer to a statute's legislative history to resolve statutory ambiguity, there is no need to do so [when the language is not unclear]"; "even were we to consider the sundry legislative comments urged in support of a congressional intent . . . , the scant history on this precise issue does not suggest a 'clearly expressed legislative inten[t] . . . contrary' . . . to the plain language of [the statute]") (citing *Consumer Prod. Safety Comm'n v. GTE Sylvania, Inc.*, 447 U.S. 102, 108 (1980)).

could not rely on the plain language of the statute, however, there still was no reason to foresee the two retroactive conditions. Although the language of both the 1985 Joint Committee Study and Senator Long's prepared statement suggests that the deduction would be *available* to the executors of persons who held appreciated securities, there is nothing in either statement or elsewhere in the legislative history petitioner has identified that suggests the deduction would be *limited* to them.[27] By contrast, Congress has explicitly included ownership and holding period requirements in other ESOP tax subsidy provisions where it intended them to apply.[28] Similarly,

[27] *See* 1985 Joint Committee Study at 37; 132 Cong. Rec. at 14507. If limited, would the class be limited to incorporators, shareholders who had purchased stock other than on the open market, shareholders of corporations that do not have publicly traded stock, or just the estates of persons who had been shareholders at the instant of death? Even if this Court were to conclude that the deduction was *intended* for the executors of shareholders who had held their stock during a period when the company grew, it should not interpret the statute as applying *only* in that context. *See, e.g., Barr v. United States*, 324 U.S. 83, 90 (1945) ("if Congress has made a choice of language which fairly brings a given situation within a statute, it is unimportant that the particular application may not have been contemplated by the legislators").

[28] Congress has included both ownership history and plan allocation requirements in some ESOP tax subsidy provisions and not in others. For example, Section 2210 (repealed 1989) (which provided for an ESOP's assumption of an estate tax liability in connection with the sale of stock by an executor to an ESOP) specifically required ownership by a decedent – but not for any particular period of time. Section 1042 (allowing a taxpayer to defer gain recognition on the sale of closely held stock to an ESOP) required a simple one-year holding period, 26

petitioner has identified nothing, whatsoever, that presaged the plan allocation rules that the Congress also seeks to impose retroactively. Not even the clairvoyance presumed by the Solicitor General in arguing the predictability of the ownership limitation could have foretold the plan allocation requirement; this change effectively repealed the deduction for any executor who acted before January 5, 1987.

Finally, petitioner implicitly contends that the executor should have anticipated the 1987 restrictions because of the factors *later* discussed during the legislative consideration of the 1987 amendments. (Br. for U.S. 4-5, 17-18, 26.) By repeating the 1987 floor statements of then-Senator Bentsen and Representative Rostenkowski,[29] petitioner implies that the purportedly unintended revenue

U.S.C. 1042(c)(1)(B) (Supp. II 1984) (repealed 1986), which the TRA changed to a requirement that the stock be long-term capital gain property (including property held for more than six months if acquired before the end of 1986 or one year thereafter and excluding property that otherwise would be treated as ordinary income property), *see* Staff of Joint Committee on Taxation, 100th Cong., 1st Sess., *Explanation of Technical Corrections to the Tax Reform Act of 1984 and Other Recent Tax Legislation* 152 (Comm. Print 1987). Section 133 (which provides for the interest exclusion for banks and mutual funds) does not restrict the use of proceeds to purchase stock based on any criterion of a selling shareholder's ownership history. Congress knew how to limit an ESOP tax subsidy with ownership history conditions when it intended to do so; it did not do so in Section 2057.

[29] This Court should exercise its traditional skepticism about the weight to be accorded the views of members of a later Congress about the intent of a former one. *See, e.g., United States v. Vogel Fertilizer Co.*, 455 U.S. 16, 34 (1982) (citing *International Bhd. of Teamsters v. United States*, 431 U.S. 324, 354 n.39 (1977)), particularly because this "intent" was not announced until a few days after the retirement of Senator Russell B. Long, who spearheaded the enactment of Section 2057 as part of the TRA and who, generally, championed the cause of ESOPs during his tenure as chairman (or ranking minority member) of the Senate Finance Committee from 1965 through 1986.

loss, which "became clear soon after the passage of the 1986 Act" (Br. for U.S. 5), should have been anticipated by the executor when he sold his MCI stock at a discount in early December 1986 and should have forewarned him of change. This position requires prescience on the part of the executor that the government itself lacked; it was not until January 5, 1987 that the Service released the advance version of Notice 87-13 and until February 26, 1987 that the chairmen of the Congressional tax-writing committees introduced legislation to restrict the availability of the Section 2057 deduction. Petitioner has identified no basis for the premise that the executor could have known of a 1986 revenue loss estimate. Moreover, as noted by the Court of Appeals, even the revised revenue loss estimate described by the legislators in February 1987 would have seemed plausible in the general context of spending for ESOPs and other qualified plans. *Carlton*, 972 F.2d at 1060.[30]

[30] Petitioner argues that Congress initially anticipated that the new deduction would cost about $300 million (over fiscal years 1987-1991) and then revised that estimate shortly after the statute was enacted to $7 billion (over the same period). (Br. for U.S. 4-5, 17, 26.) Although those cost estimates were contained in the statements made by Representative Rostenkowski, 133 Cong. Rec. 4145 (1987), and Senator Bentsen, 133 Cong. Rec. 4294 (1987), when the 1987 "clarifying" legislation was introduced on February 26, 1987, there is no evidence that the executor knew, should have known, or even could have known of the two estimates when he sold his MCI stock to its ESOP.

In summary, the Court of Appeals was correct when it concluded that the 1987 changes were not foreseeable:

> It is undisputed that Carlton had no actual notice of the 1987 amendment imposing the decedent ownership requirement when he completed the MCI ESOP transaction in 1986. Nor is there any basis upon which Carlton could have had constructive notice of the future imposition of the decedent ownership requirement.

972 F.2d at 1059.

Even if the revised cost estimate had been known in the fall of 1986, there is no reason to believe that a reasonable executor would have concluded that an ownership requirement and plan allocation requirement had been omitted inadvertently from the statute. In December 1986, the General Accounting Office reported that over the seven-year period from 1977 through 1983, tax incentives for ESOPs cost between $12.1 billion and $13.3 billion compared with total ESOP assets of about $19 billion in 1983. *Employee Stock Ownership Plans: Benefits and Costs of ESOP Tax Incentives for Broadening Stock Ownership* (GAO/PEMD 87-88) 1 (1986). Similarly, the 1985 Joint Committee Study reports that: "the tax expenditure for [all] qualified plans [including ESOPs] is the largest single item of tax expenditures. For fiscal year 1986, the tax expenditure for employer-maintained qualified plans (including Keogh plans) is estimated to be $56.8 billion, and this expenditure is projected to increase to $88.9 billion for fiscal year 1990. For fiscal years 1986 through 1990, the total expenditure is estimated to be $359.8 billion." 1985 Joint Committee Study at 21 n.29.

III. THE GOVERNMENT'S SUPPORT FOR THE RESULT IT SEEKS IN THIS CASE DOES NOT WITHSTAND CAREFUL ANALYSIS.

A. The Circumstances of this Case Readily Distinguish it from those in which the Court Has Upheld Retroactive Taxation.

The government's inducement of a below-market sale that no taxpayer otherwise would have made and the absence of actual or constructive notice that would have made the 1987 changes foreseeable distinguish this case. None of the cases cited by petitioner involves similar circumstances.

1. Legislation Pending and Ratification Cases.

Statutory change was easily foreseeable in a number of the cases cited by the Solicitor General that involve action while a legislative proposal was under consideration or after one had been under consideration in an adjourned legislative session. For example, in *Cooper v. United States*, 280 U.S. 409 (1930), the Finance Committee had described the kind of transaction engaged in by the Coopers as a specific abuse of the income tax law to be eliminated by proposed legislation *several weeks before* their gift and sale.[31] Similarly, in *Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*, 467 U.S. 717 (1984), the Court concluded that retroactive application during legislative consideration "prevented employers from taking advantage of a lengthy legislative process and withdrawing

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[31] S. Rep. No. 375, 67th Cong., 1st Sess. 10 (Sept. 26, 1921).

[from multi-employer pension plans] while Congress debated necessary revisions in the statute," 467 U.S. at 731.[32] Finally, in *United States v. Hemme*, 476 U.S. 558 (1986), the separate exemptions for the estate and gift taxes had been replaced with the unified credit that is applied to both, and the Court upheld a transition rule intended to prevent taxpayers from exploiting the planned change between the date the Conference Committee approved the bill and its effective date.[33]

Change also was foreseeable in a group of cases cited by the Solicitor General involving instances where the Executive had sent a message to Congress calling for the legislation.[34] *Ferman v. United States*, 993 F.2d 485 (5th Cir.

[32] *Accord Concrete Pipe & Prods. of California, Inc. v. Construction Laborers Pension Trust*, 113 S. Ct. 2264 (1993).

[33] Mr. Hirschi made his gifts three weeks *after* the Conference Committee action and less than one week before the President signed the bill. *Hemme*, 476 U.S. at 562-63. The Solicitor General also cites three other estate tax cases arising out of the unification of the estate and gift tax systems in the late 1970s in which the taxpayer acted during legislative consideration. *Estate of Ekins v. Commissioner*, 797 F.2d 481 (7th Cir. 1986); *Reed v. United States*, 743 F.2d 481 (7th Cir. 1984), *cert. denied*, 471 U.S. 1135 (1985); and *Estate of Ceppi v. Commissioner*, 698 F.2d 17 (1st Cir.), *cert. denied*, 462 U.S. 1120 (1983).

[34] These include *United States v. Hudson*, 299 U.S. 498 (1937) (legislation to stem silver speculation in anticipation of Depression-era government purchases); *Purvis v. United States*, 501 F.2d 311 (9th Cir. 1974), *cert. denied*, 420 U.S. 947 (1975), and *First Nat'l Bank in Dallas v. United States*, 420 F.2d 725 (Ct. Cl.), *cert. denied*, 398 U.S. 950 (1970) (each involving the 1963 interest equalization tax to reduce foreign investment); and, *Sidney v. Commissioner*, 273 F.2d 928 (2d Cir. 1960) (change in the collapsible corporation rules by categorizing a distribution as ordinary

1993), *petition for cert. filed*, 62 U.S.L.W. 3299 (U.S. Oct. 12, 1993) (No. 93-569)), deals with the effect of the Notice (which suggested the two additional conditions on the Section 2057 deduction): Does a sale after the Notice but before the introduction of the 1987 legislation fall within this line of cases? The Fifth Circuit effectively concluded that it does. 993 F.2d at 491. *See also Carlton*, 972 F.2d at 1062 (dictum).

Finally, change was particularly foreseeable in cases cited by the Solicitor General in which Congress ratified a prior regulatory or administrative practice. For example, *Graham & Foster v. Goodcell*, 282 U.S. 409 (1931), involved a group of tax refund suits concerning the collection of income and World War I excess profits tax after the expiration of the statute of limitations. The government had erroneously believed that the statute was tolled by consideration of abatement claims. After the Court decided otherwise, a number of taxpayers filed refund claims. Congress provided that no refund was due, and the taxpayers then challenged the application of that provision to their refund actions on Due Process grounds. Retroactive application avoided a windfall to the taxpayers and produced the expected result. Reliance by the

income rather than capital gain to the shareholder). See also *Brushaber v. Union Pac. R.R.*, 240 U.S. 1 (1916), a broad challenge to the income tax enacted shortly after the Sixteenth Amendment that included a challenge to its application for the period between its March 1 effective date and enactment on October 3. Because the amendment, itself, had been ratified on February 3, 1913, the adoption of a federal income tax could hardly have been more foreseeable.

taxpayer was not an issue, and the government certainly did not induce the taxpayer's underlying behavior.[35]

2. Tax Administration and Rate Cases.

The Court consistently has upheld Congress's power to change the specific ways in which existing tax laws are administered with respect to taxable events and rates of tax and to apply those changes to periods for which returns have not yet been filed. In this vein, petitioner argues that a taxpayer ought to expect changes in the tax laws (Br. for U.S. 20), quoting the opinion of Judge Learned Hand in *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930). That case involved entertainer George M. Cohan, who shifted his fiscal year for income tax purposes in January of 1921. Later that year, the statute providing for the treatment of "short" years was amended to require "annualization" of income. Cohan complained that he had received several payments during his short year that were not representative of an

[35] Other cases include *New England Baptist Hosp. v. United States*, 807 F.2d 280 (1st Cir. 1986), *Canisius College v. United States*, 799 F.2d 18 (2d Cir. 1986), *cert. denied*, 481 U.S. 1014 (1987), and *Temple Univ. v. United States*, 769 F.2d 126 (3d Cir. 1985), *cert. denied*, 476 U.S. 1182 (1986). All arose out of Congress's ratification of an IRS ruling position that the taxpayers had followed at the time they had filed their returns. The factual contrast with the present controversy is striking: The employees had made retirement annuity contributions and the employers had paid FICA taxes assuming that the retirement annuity contributions would constitute wages for FICA purposes; as the law evolved, the expectations were satisfied. See also *United States v. Heinszen & Co.*, 206 U.S. 370 (1907) (ratification of Executive Order for collection of tariffs in Philippines).

entire 12-month period. Judge Hand rejected Cohan's complaint, contrasting it with another:

> His is a different case from that of one who, when he takes such action, has no reason to suppose that any transactions of the sort will be taxed at all.

39 F.2d at 545. Here, the executor would not have made the below-market sale to the ESOP but for the estate tax deduction; application of the retroactive changes would be even more egregious than in Judge Hand's contrasting situation in *Cohan*.[36]

Another example of this sort of "routine" change is *Milliken v. United States*, 283 U.S. 15 (1931), in which the

[36] *Sidney v. Commissioner*, 273 F.2d 928 (2d Cir. 1960), involved a change in the collapsible corporation rules by categorizing a distribution as ordinary income rather than capital gain to the shareholder. Judge Friendly observed: "The distribution in the instant case was of a sort long subject to Federal income taxation; § 117(m) changed the law only as to the category of income and consequently the rate." 273 F.2d at 932. (Moreover, the distributions involved were made *after* President Truman's message proposing the change. 273 F.2d at 932.) From a more recent era, *United States v. Darusmont*, 449 U.S. 292 (1981) (per curiam), *Westwick v. Commissioner*, 636 F.2d 291 (10th Cir. 1980), *and Buttke v. Commissioner*, 625 F.2d 202 (8th Cir. 1980), are similar. All arose out of a 1976 change in the computation of the minimum tax. (In each, the sale also was made while the proposed legislation was under consideration, and in none was there any showing of detrimental reliance by the taxpayer. In *Darusmont*, for example, the taxpayer was not even aware of the minimum tax when deciding how to structure the sale. 449 U.S. at 295.) The most recent of this line of cases is *Wiggins v. Commissioner*, 904 F.2d 311 (5th Cir. 1990) (1984 change to the computation of alternative minimum tax for 1983).

Court upheld an increase in the estate tax rate between the time when an includable gift was made and the donor's death.

> Decedent's gift as a substitute for a testamentary disposition was . . . brought within the operation of the 1916 Act taxing such gifts on the same basis, with respect to rate and valuation as transfers of property at death. Not only was the decedent left in no uncertainty that the gift he was then making was subject to the provisions of the existing statute, but in view of its well-understood purpose, he should be regarded as taking his chances of any increase in the tax burden which might result from carrying out the established policy of taxation under which substitutes for testamentary gifts were classed and taxed with them.

283 U.S. at 23.

Several of the cases cited by the Solicitor General involve the income taxation of multi-year transactions where changes in the law in future years are inherently foreseeable. *Shanahan v. United States*, 447 F.2d 1082 (10th Cir. 1971), *Lawler v. Commissioner*, 78 F.2d 567 (9th Cir. 1935), and *Rose v. Commissioner*, 55 T.C. 28 (1970), all concern installment sales in which the taxpayer knew that part of the gain would be taxed in future years. (Indeed, the sales in *Shanahan* and *Rose* were made while the legislation was under consideration.) *Miller v. Commissioner*, 115 F.2d 479 (9th Cir. 1940), *cert. denied*, 312 U.S. 703 (1941), concerns the treatment of a loss carryforward, and *Estate of Papson v. Commissioner*, 81 T.C. 105 (1983), concerns merely a change in the interest rate for deferred estate tax payments.

Although changes in tax administration and rates of the type involved in this line of cases were foreseeable, inducing a below-market sale and, then, reneging on the tax benefit was not.

3. Absence of Reliance Cases.

Regardless whether change clearly was foreseeable or whether a change was simply in the administration of existing tax laws, the record in some cases is devoid of any evidence of reliance on the existing state of the law by the taxpayer.

In *Welch v. Henry*, 305 U.S. 134 (1938), for example, Wisconsin's 1933 income tax statute had allowed a deduction for dividends received from corporations whose principal business was attributable to Wisconsin. Because most of Welch's gross income for that year consisted of such dividends, his return filed in the spring of 1934 showed no taxable income for 1933. At the next legislative session (in 1935), Wisconsin modified its income tax law to impose new taxes for 1933 and 1934 to raise money for unemployment relief which effectively rescinded the deduction for "Wisconsin dividends" for 1933. The Court rejected both Equal Protection and Due Process challenges to the Wisconsin action. Insofar as the latter is concerned, Justice Stone noted the long federal history of amending the income tax law to apply to the year of enactment "and in some instances during the year of the preceding session," 305 U.S. at 148, and concluded that the 1935 Wisconsin tax on dividends of in-state companies received "during the year of the legislative session preceding that of its enactment" did not violate Due Process. 305 U.S. at 150-51. Although the 1933 deduction

may have encouraged Welch to invest in his home state, there is no suggestion in the record that Welch would not have invested in the Wisconsin stock but for the provisions of the 1933 legislation. Indeed, Justice Stone observed:

> We can not assume that stockholders would refuse to receive corporate dividends even if they knew that their receipt would later be subjected to a new tax or to the increase of an old one.

305 U.S. at 148.

In *General Motors Corp. v. Romein*, 112 S. Ct. 1105 (1992), the absence of reasonable reliance on the existing state of the law was even clearer. The employer repeatedly paid reduced workers compensation benefits in the face of substantial controversy about the effective date of a statutory change allowing "benefit coordination." "Refund" legislation did not offend Due Process.[37]

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[37] In *Stockdale v. Insurance Cos.*, 87 U.S. (20 Wall.) 323 (1874), a divided court upheld the validity of an income tax collected from corporations on dividends attributable to income earned between July 1869 and June 1870; the tax had been in force since 1863, and the question was when it expired; the taxpayer made no detrimental reliance argument, and the Court considered no Due Process argument. In *Fein v. United States*, 730 F.2d 1211 (8th Cir.), *cert. denied* 469 U.S. 858 (1984), the taxpayer made a premortem life insurance transfer of a kind traditionally causing inclusion of the proceeds in a decedent's gross estate for estate tax purposes. Moreover, the insurance would have been subject to tax if not transferred, so that retroactive application of the statutory change did not make the situation of the taxpayers any worse than if they had not transferred the insurance. Finally, the Court of Appeals specifically noted the absence of any showing of reliance by the taxpayer. 730 F.2d at 1213.

Other cases cited by petitioner involve activities affirmatively discouraged by social policy, not encouraged, and in which the taxpayer certainly could not have relied reasonably on the existing language of the statutes;[38] in contrast, inducing below-market sales to ESOPs was the purpose of Section 2057.

4. Cost Allocation Cases.

Finally, the Solicitor General cites two cases in which some citizens received the benefit of a particular government program that others did not.[39] In *Usery v. Turner*

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[38] For example, *Long v. IRS*, 742 F.2d 1173 (9th Cir. 1984), involved a FOIA attempt to obtain information about the taxpayer compliance measurement program. Retroactive application was appropriate to prevent subversion of the administration of the tax laws. Similarly, *DeMartino v. Commissioner*, 862 F.2d 400 (2d Cir. 1988), arose out of a sham transaction that did not even rise to the technical definition of a tax-motivated straddle. Retroactive application of an unusually high interest rate on the resulting tax deficiency (as if the transaction had been a tax-motivated straddle) was justified.

[39] *Gray*, discussed *supra* text accompanying note 32, also involves a cost allocation issue. Before the 1980 amendments, employers withdrawing from multi-employer pension plans potentially were liable if the plan terminated within five years and lacked sufficient funds to pay benefits, 467 U.S. at 720-21; after the amendments, employers withdrawing from underfunded plans were liable immediately for their pro rata share of the shortfall, *id.* at 723. In each case, withdrawing employers were being charged with the cost of underfunding benefits for those in a pool of workers that included their employees, and the 1980 amendments merely changed the way in which employers withdrawing from multi-employer plans would bear a share of the underfunding from which they, presumably, had received the benefit of lower labor costs.

Elkhorn Mining Co., 428 U.S. 1 (1976), the Court found that imposition of the costs of black lung disease benefits on the operators and coal consumers, who (generically) had received the benefit of the workers' labor, was a rational way for Congress to allocate those costs. 428 U.S. at 18. Similarly, in *United States v. Sperry Corp.*, 493 U.S. 52 (1989), the Court determined that allocation of the costs of the United States' Claims Tribunal through a user fee applying to all who had received the benefit of the Tribunal (and not just those whose awards became effective after the date of enactment) was a rational way of allocating the costs of the Tribunal.[40]

The facts of the cases cited by the Solicitor General stand in stark contrast to those here. Neither Mrs. Day nor her executor enjoyed (1) the economic benefit of prior conduct that gave rise to a particular cost, as was the case in *Turner Elkhorn*, or (2) the peculiar benefit of a current government program available only to the few, as was the case in *Sperry*. Mrs. Day's executor acted before any legislative or executive branch activity suggesting a likely change. Unlike the periodic changes in the administration of the tax law and rate changes the Court has approved in the past, Congress here seeks to deprive the executor of *both* his share of the expected tax savings *and* the share that he irrevocably transferred to the ESOP. *Unlike the taxpayers in all of the cases cited by petitioner*, Mrs. Day's

[40] The Iranian government did not approve the *Sperry* settlement until July 1982, and the Treasury issued its directive for the "user fee" in June 1982, 493 U.S. at 56-57, arguably making *Sperry* a member of the "legislation pending and ratification" category of cases discussed *supra* notes 31-35 and accompanying text.

executor was specifically induced to make the below-market sale by Section 2057 when otherwise there would have been no reason, whatsoever, for him to do so. Application of the *post hoc* amendments *in this case* would be particularly "harsh and oppressive."

B. The Solicitor General Offers No Support for Retroactive Application in the Circumstances of this Case.

Just as the cases cited by the Solicitor General fail to provide a basis for retroactive taxation here, his arguments to support the retroactive narrowing of the ESOP subsidy with the decedent ownership and plan allocation requirements do not withstand careful analysis. The retroactive amendments did not prevent "sham" transactions, they did not establish a uniform rule for all estates to which the deduction was available, and they were not a rational means of raising revenue for the fisc. Describing changes as "curative" is of no help analytically, and retroactive application here would represent a triumph of Congressional myopia.

1. The Sham Transaction Theory.

Retroactive application of the changes to Section 2057 was not a rational means to prevent revenue loss as a result of "sham" transactions in pursuit of the goal of preventing evasion of the tax law "by the vigilant and ingenious" (Br. for the U.S. 15), because this transaction was one of economic substance and not one disguised in

form to obtain favorable tax treatment.[41] The executor's below-market sale was exactly what it purported to be; it accomplished a transfer of wealth from the beneficiaries of Mrs. Day's estate to the ESOP participants. The form and economics of this transaction for Mrs. Day's estate are the same as (and no more a sham than) they would have been had (1) Mrs. Day owned the stock before her death and (2) the plan agreed to allocate the stock in the fashion required by the 1987 amendments. Moreover, Mrs. Day's executor bore the economic risk of potential changes in the market value of the stock, just as if Mrs. Day had owned the MCI stock before her death.[42]

Although the government and the taxpayer have stipulated, in effect, to his vigilance (Br. in Opp. App. 50a), the executor can hardly be called "ingenious" in

[41] *Cf., e.g., Knetsch v. United States*, 364 U.S. 361 (1960) (leveraged single-premium deferred annuity "investment" in which borrowings kept cash value nominal and precluded accrual of any material annuity benefit); *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945) (liquidating dividend followed by shareholder sale to buyer who had negotiated the terms of purchase from the corporation recharacterized as a direct sale by the corporation); *Gregory v. Helvering*, 293 U.S. 465 (1935) (in-kind distribution of appreciated securities through a corporate reorganization where sole shareholder formed new company solely to participate in the transaction and then immediately liquidated it recharacterized as a dividend).

[42] Although the executor held this stock for only a relatively short time, the holding period also would have been short if Mrs. Day had bought the stock on her deathbed and her executor had sold it immediately after her death. The critical issue is not the length of time the executor bore market risk, but that he did.

view of the plain language of Section 2057. As the Court of Appeals commented:

> The federal government has long sought to promote employee ownership of shares in their employers. Section 2057 was enacted to induce taxpayers to sell shares at a discounted price to an ESOP, thus furthering the public policy of employee ownership. As intended, the Day estate succumbed to the lure and sold shares to the MCI ESOP at a substantial discount. Section 2057 worked. An ESOP was able to buy more shares at a lower price than before. Then, when the private actor had completed the socially desirable action of selling shares at a discount to an ESOP, the government reneged on its end of the deal. It was too late for Carlton to undo his sale to the MCI ESOP. The $631,000 was gone forever, irretrievable.

Carlton, 972 F. 2d at 1060.

Whenever the tax law is used to promote social goals, Congress intends to affect taxpayer behavior. Surely, the Solicitor General cannot be correct when he suggests that taxpayers lose the protection of Due Process simply because behavior can be labeled "tax motivated" or "tax avoidance." (Br. for U.S. 11, 17 & n.13, 26, 27 n.19.)[43] The

[43] Although the Solicitor General derides "tax motivated" transactions, Judge Learned Hand succinctly observed that: "a transaction, otherwise within an exception of the tax law, does not lose its immunity, *[sic]* because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.

transaction here is no more suspect than a bank's stock acquisition loan to an ESOP at a below-market interest rate that is motivated by the bank's desire to exclude one-half of the interest from its taxable income.[44] Just as it would violate Due Process to add conditions retroactively to Section 133, making the exclusion inapplicable to interest income received by a bank from loans already made, it also violates Due Process to apply the two conditions suggested by the Notice retroactively.

2. The Uniform Application Theory.

Petitioner suggests that retroactive application of the decedent ownership and plan allocation requirements to this transaction would provide "a uniform rule for all estates to which the deduction is available." (Br. for U.S. 19.) To the contrary, the 1987 amendments to Section 2057 neither provide a uniform rule for the application of the ESOP proceeds deduction nor represent a rational means to achieve uniformity. The "curative" legislation narrowed the scope of Section 2057 by imposing ten restrictions on the deduction not contained in the initial statute. Two, the decedent ownership requirement and the plan allocation requirement, are to operate as if included from the outset, Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203 § 10411, 101 Stat. 1330, 1330-432 to

Therefore, if what was done here was what was intended by [the section involved], it is of no consequence that it was all an elaborate scheme to get rid of income taxes, as it certainly was." *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd sub nom. Gregory v. Helvering*, 293 U.S. 465 (1935).

[44] See *supra* note 23 and accompanying text.

1330-433, and the remaining eight[45] are to be effective only for sales after February 26, 1987, the date the 1987 legislation was introduced, *id.*, § 10412(b), 101 Stat. at 1330-435 to 1330-436. The 100th Congress provided two rules, not one. Moreover, executors considering ESOP sales after February 26th had the opportunity to know of and base their conduct on the proposal that 100th Congress ultimately used to narrow dramatically the scope of the deduction. Executors considering ESOP sales after January 5th had a reason to foresee the possible addition of the decedent ownership and plan allocation requirements. Executors acting before January 5th, however, had no basis to foresee the possible changes. Applying the same restrictions to them as to those who acted between January 5 and February 26 is singularly arbitrary, because

[45] These were (1) a limit on the maximum deduction (the lesser of that deduction that would result in a $750,000 tax savings or a deduction equal to one-half of the taxable estate without the deduction), (2) a reduction of the sales proceeds that could qualify in the event the ESOP had purchased or sold employer securities in the prior year, (3) a disqualification of proceeds attributable to assets transferred to an ESOP from other forms of tax-exempt retirement plans (unless the Service determined otherwise), (4) a requirement that proceeds be received before the estate tax return was due, (5) a disqualification of stock a decedent acquired as compensation (whether tax-deferred or not) from the employer, (6) a limit to securities of an issuer that does not have any stock that is readily tradable on an established securities market, (7) a holding period requirement dating back to October 22, 1986 for the decedent or his or her spouse, and (8) a provision that disqualified stock if the decedent had engaged in certain kinds of hedging transactions to reduce the risk of loss if the stock declined in value. Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10412(a), 101 Stat. 1330, 1330-433 to 1330-435.

it would deprive them of the benefit that induced their below-market sales without warning.[46]

The Solicitor General's uniform allocation theory proves too much: It would eviscerate the Due Process limit on retroactive taxation, because Congress could justify the *post hoc* application of *any* change on this ground. Without considering whether the means employed to achieve an objective results in an unduly "harsh and oppressive" effect on the taxpayer, this theory would eliminate any distinction between Congressional exercise of the Taxing Power prospectively and retroactively. It ignores the particular burden carried by retroactive legislation.[47]

3. The Revenue Raising Theory.

Although petitioner does not explicitly argue that the Taxing Power is entirely unconstrained by the Due Process Clause, he implicitly adopts that position in a third rationale for retroactive application of the 1987 changes in Section 2057, "to distribute increased costs of government among its taxpayers in light of present need for revenue." (Br. for U.S. 19 n.16.) To permit retroactive taxation solely because it increases tax revenue, without

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[46] The only discernable distinction between the two restictions that were to apply to all ESOP sales and the additional eight to be applied prospectively was that the decedent ownership and plan allocation rules were presaged by the Notice. There was no difference, however, in the foreseeability of any of the ten before release of the advance version of the Notice on January 5, 1987.

[47] See *supra* note 5 and accompanying text.

further inquiry, would eliminate any Due Process constraint, just as would the uniform application theory. The government always could justify a retroactive tax on the ground that it needs to increase revenue.[48]

4. The Closing a Loophole Theory.

To describe a change as "closing a loophole" or "curing a drafting error" simply announces a conclusion that retroactive application is permissible; it does not explain why. Notwithstanding post-transaction rhetoric, there is nothing in the legislative history to the 1986 statute that was available at the time the executor engaged in the transaction to disclose the two additional conditions for the deduction.[49] The Notice itself is persuasive evidence of the absence of any reason for the taxpayer to have anticipated the changes before January 5, 1987; if the intent had existed and been manifest in the legislative history of the TRA, there would have been no need for

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[48] There is nothing in the record to suggest that prospective application of the two additional requirements from either February 26, 1987 (when the legislation was introduced) or January 5, 1987 (when the advance version of the Notice was released) would not produce roughly the same revenue result as retroactive application, notwithstanding the Solicitor General's implication to the contrary. (Br. for U.S. 4-5, 17, 26.)

[49] Moreover, the taxpayer respectfully suggests that even if one or more members of Congress did (secretly) intend to include the additional requirements to qualify for the deduction, that undisclosed intent is irrelevant. The executor's conduct could not have been guided by the undisclosed or unarticulated intent of one or more members of Congress or its staff.

the Notice or the self-serving declarations of the Congressional tax leaders in the early part of 1987. While Congressional "intent" may be relevant if a statute is at odds with specific discussion of its expected application during the legislative process (as in the case that would arise if the term "not" were added or omitted), the absence of any discussion of decedent ownership and plan allocation limits should be dispositive.

5. Congressional Myopia.

Application of the 1987 restrictions to the Day estate transaction would represent a triumph of Congressional myopia: Adopting petitioner's view that Due Process permits retroactive application in this case will discourage taxpayers from behaving in the future as the government wants them to behave.[50] The additional uncertainty that

[50] Absent a definite, overt indication in the legislative history that the plain language of a statute is incorrect, how is a taxpayer to distinguish between a policy choice and a drafting error? How long should a prudent banker wait for possible legislative change before making a share acquisition loan to an ESOP at a below-market interest rate and thereby sharing with the ESOP participants and the corporate sponsor the benefit of the bank's ability to exclude one-half of the interest from taxable income under 26 U.S.C. § 133 (Supp. IV 1992)? What about a shareholder willing to sell stock at a discount from fair market value because of the tax deferral available under 26 U.S.C. § 1042 (Supp. IV 1992) or an executor who was willing to sell stock to an ESOP at a below-market price in a transaction in which the ESOP assumed (and the company guaranteed) the obligation to pay estate tax under Section 2210 (before its 1989 repeal)?

an apparently clear tax statute may be changed retroactively to impose an unexpected loss will cause those in the future to be reluctant to engage in "unproven" transactions and, consequently, reduce the amount of the tax benefit shared with the intended beneficiaries of tax policy. As Justice Cardozo said, "[l]aw as a guide to conduct is reduced to the level of mere futility if it is unknown and unknowable." Benjamin N. Cardozo, *The Growth of the Law* 3 (1924).

CONCLUSION

Application of the retroactive changes to Section 2057 in this case transgresses the Due Process limit, because it would be "harsh and oppressive." The changes were not foreseeable, the taxpayer would have acted differently had he foreseen them, he sustained actual injury, and his dedication of estate resources to pursue the public goal of ESOP funding was specifically induced by Section 2057. The facts here stand in stark contrast to the cases cited by petitioner in which retroactive legislation has been sustained. Similarly, petitioner has not advanced anything in the "nature of the tax and the circumstances in which it is laid" that justifies imposing the particularly "harsh and oppressive" result of retroactive application in this case. The decision of the Court of Appeals should be affirmed.

Respectfully submitted,

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December 1993

(9)

No. 92-1941

In the Supreme Court of the United States

OCTOBER TERM, 1993

UNITED STATES OF AMERICA, PETITIONER

v.

JERRY W. CARLTON

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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TABLE OF AUTHORITIES

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1. Respondent invites the Court to discern in the guaranty of "due process of law" (U.S. Const. Amend. V) a constitutional mandate to strike down economic legislation that reaches results that are too "harsh" or "oppressive." The broad and subjective role that respondent asks this Court to undertake is one that the Court has frequently and firmly rejected.

Depending on one's personal point of view, and on one's economic status, the imposition of a particular tax may be seen as harsh or "unreasonable" (*Untermyer* v. *Anderson*, 276 U.S. 440, 447 (1928) (Brandeis, J., dissenting)) or, instead, as the price "we pay for civilized society" (*Compania General de Tabacos de Filipinas* v. *Collector*, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting)). It has never, to our knowledge, been suggested that the guaranty of "due pro-

cess of law" empowers this Court to invalidate *prospective* tax legislation on the subjective grounds that the tax is unfair, unwise, "harsh" or "oppressive." In authorizing the Legislative Branch "to lay and collect taxes" (U.S. Const. Art. I, § 8), the Constitution does not specify that Congress may enact only "fair" taxes and must avoid "harsh" taxes. The "fairness" or "harshness" of taxation is peculiarly a social and political judgment, to be made by the Legislature, not the Judiciary. The Founders designed the Constitution to ensure that the fairness of taxation would be resolved in representative, not judicial, debates.

As Justice Holmes concluded, the guaranty of "due process of law" has no different text for *retroactive* than for *prospective* adjustments to tax legislation. The Constitution affords no basis for a court to "state * * * articulately the ground for denying the power of Congress to lay [a retroactive] tax. * * * A tax may be levied for past privileges and protection as well as for those to come." *Untermyer* v. *Anderson*, 276 U.S. at 446 (Holmes, J., dissenting). Indeed, prior to 1927, "no federal revenue measure ha[d] ever been held invalid on the score of retroactivity." *Id.* at 449 (Brandeis, J., dissenting):

> For more than half a century, it has been settled that a law of Congress imposing a tax may be retroactive in its operation. * * * Each of the fifteen income tax acts adopted from time to time during the last sixty-seven years has been retroactive, in that it applied to income earned prior to the passage of the act, during the calendar year. The Act of October 3, 1913, c. 16, 38 Stat. 114, 166, which taxed all incomes received after March 1, 1913, was specifically upheld in *Brushaber* v. *Union Pacific R.R. Co.*, 240 U.S. 1, 20, and in *Lynch* v. *Hornby*, 247 U.S. 339, 343. Some of the acts have taxed income earned in an earlier year. * * * The Act of February 24, 1919, c. 18, Title II, 40 Stat. 1057, 1058-1088, which taxed incomes for the calendar year 1918, was applied, without question as to its constitutionality, in *United States* v. *Robbins*, 269 U.S. 315, and numerous other cases.
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> * * * [R]etroactive legislation [imposing special assessments on property] has been sustained, although the * * * statute was not enacted until after the property benefited [by improvements retroactively funded by the assessment] had passed to a bona fide purchaser without notice of any claim that it had been, or might be, assessed for a benefit. *Seattle* v. *Kelleher*, 195 U.S. 351. * * * The right of the Philippine Government to retain import and export duties laid and collected without authority, was sustained where thereafter Congress by retroactive legislation confirmed the unlawful action in collecting the duties. *United States* v. *Heinszen & Co.*, 206 U.S. 370; *Rafferty* v. *Smith, Bell & Co.*, 257 U.S. 226. Liability for taxes under retroactive legislation has been "one of the notorious incidents of social life." *Seattle* v. *Kelleher*, 195 U.S. 351, 360. Recently this Court recognized broadly that "a tax may be imposed in respect of past benefits." *Forbes Boat Line* v. *Board of Commissioners*, 258 U.S. 338, 339.

Id. at 447-450 (Brandeis, J., dissenting).

In three decisions during the 1920's, however, the Court rejected the retroactive application of federal taxes which the Court concluded would be "wholly unreasonable" (*Blodgett* v. *Holden*, 275 U.S. 142, 147 (1927) (opinion of McReynolds, J.)) or "whimsical and burdensome" (*Nichols* v. *Coolidge*, 274 U.S. 531, 542 (1927)). In the years that followed, the

Court, of course, ultimately embraced the views of Justices Holmes and Brandeis in dissent from the "substantive" due process holdings of the *Lochner* era. See, *e.g.*, *Nebbia* v. *New York*, 291 U.S. 502, 525 (1934); Pet. Br. 12-14 & 13 n.10. The Court also specifically rejected the standardless proposition that emanated from that era—and that respondent renews here—that a tax may be declared unconstitutional if, in the view of a reviewing court, it is thought to be too unreasonable, "harsh" or "oppressive."[1]

The Court has instead held on several recent occasions that (i) retroactive economic and tax legislation is entitled to the same presumption of validity as prospective legislation and (ii) the burden of sustaining retroactive legislation under the Due Process Clause, against a challenge that the legislation is too "harsh" and "oppressive," is "met simply by showing that the retroactive application of the legislation is itself justified by a rational legislative purpose." *Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. 717, 733 (1984).

> [A]lthough we have noted that retrospective civil legislation may offend due process if it is "particularly 'harsh and oppressive,'" [*United States Trust Co.* v. *New Jersey*, 431 U.S. 1, 17 n.13 (1977)] (quoting *Welch* v. *Henry*, 305 U.S. 134, 147 (1938) * * *), that standard does not differ from the prohibition against arbitrary and irrational legislation that we clearly enunciated in *Turner Elkhorn*.

Pension Benefit Guaranty Corp. v. *R.A. Gray & Co.*, 467 U.S. at 733. As the Court stated in *General Motors Corp.* v. *Romein*, 112 S. Ct. 1105 (1992), even though "[r]etroactive legislation presents problems of unfairness that are more serious than those posed by prospective legislation," "the test of due process" for the "retroactive aspects of [economic] legislation, as well as the prospective aspects," is whether they advance "a legitimate legislative purpose * * * by rational means."[2] *Id.* at 1112, quoting *Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. 730. See also Pet. Br. 14 (citing cases).

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[1] A constitutional inquiry in that subjective form is an inadequate basis for "the exercise of [this Court's] high prerogative of declaring invalid an act of Congress" (*Untermyer* v. *Anderson*, 276 U.S. at 453 (Brandeis, J., dissenting). As Justice Brandeis properly concluded (*id.* at 454):

> "One branch of the government cannot encroach on the domain of another without danger. The safety of our institutions depends in no small degree on a strict observance of this salutary rule." [*Sinking-Fund Cases*, 99 U.S. 700, 718 (1878).] * * * The presumption [that legislation is valid] should be particularly strong where, as here, the objection to an act arises not from a specific limitation or prohibition on Congressional power but only out of the "vague contours of the Fifth Amendment, prohibiting the depriving any person of liberty or property without due process of law," Mr. Justice Holmes, in *Adkins* v. *Children's Hospital*, 261 U.S. 525, 568.

[2] The *amici* candidly acknowledge that the standard of review under the Due Process Clause described by this Court in *Pension Benefits Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 729-730, and in *General Motors Corp.* v. *Romein*, 112 S. Ct. at 1112, is the "current standard" used by "modern courts" (*Am.* American Cause Br. 12; *Am.* Washington Legal Foundation, et al., Br. 6). *Amici* Washington Legal Foundation, et al., contend (Br. 12-28), however, that retroactive application of the 1987 amendment to Section 2057 should be stricken as an "ex post facto" law under Article I of the Constitution. That provision states that "No Bill of Attainder or ex post facto Law shall be passed" (U.S. Const. Art. I, § 9, Cl. 3). Since 1798, in *Calder* v. *Bull*, 3 U.S. (3 Dall.) 386 (1798), the Court has consistently interpreted the prohibition of "ex post facto" laws to apply only to criminal enactments and to have no application to retroactive civil legislation. The Court recently noted that this "exclusive definition of *ex post facto* laws" stems from its existence as "a term of art with an established meaning at the time of the framing of the Constitution." *Collins* v. *Youngblood*, 497 U.S. 37, 41-42 (1990).

This case, in any event, presents no occasion for review of this Court's well-established interpretation of the "ex post facto" clause. Respondent

It is evident that the novel, three-part substantive due process test adopted and applied by the court of appeals in this case strays far from this Court's modern decisions. The question ultimately posed by the court below, through its three-part analysis, is whether it is too "harsh" or "oppressive" to impose a retroactive tax that "upsets [respondent's] otherwise settled expectations" or "impose[s] a new duty or liability based on [respondent's] past acts" (*Usery* v. *Turner Elkhorn Mining Co.*, 428 U.S. 1, 16 (1976)). The Court has clearly and expressly held, however, that these very concerns are not sufficient to condemn a retroactive tax under the Due Process Clause. *Ibid.*[3] Instead, the due process inquiry for economic legislation is "simply [whether] the retroactive application of the legislation is itself justified by a rational legislative purpose." *Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 730. Accord, *United States* v. *Sperry Corp.*, 493 U.S. 52, 64-65 (1989).[4]

has raised no challenge to the statute under the "ex post facto" clause, either in the courts below or in its brief in this Court. The courts below accordingly had no occasion to, and did not, address the application, if any, of the "ex post facto" clause to this case. Nor is that issue within the scope of the question presented in the petition in this case (Pet. I). Respondent's only challenge to the statute is his assertion that, as applied to the estate's December 1986 transaction, the statute violates the Due Process Clause of the Fifth Amendment to the Constitution. See Complaint ¶ 35(c), at 13 (Tr. Doc. 1).

[3] *Amicus* American Cause thus plainly errs in contending that "any tax law which disturbs settled expectations should be viewed as harsh and oppressive" (*Am.* Br. 2). See *Usery* v. *Turner Elkhorn Mining Co.*, 428 U.S. at 16 (citing cases):

> [O]ur cases are clear that legislation readjusting rights and burdens is not unlawful solely because it upsets otherwise settled expectations. * * * This is true even though the effect of the legislation is to impose a new duty or liability based on past acts.

[4] Remarkably, of the several Members of Congress who join in a brief that asks the Court to invalidate the retroactive 1987 statute as an example of the "tyranny" of the majority (*Am.* Washington Legal Foun-

2. Respondent correctly notes that "[w]hat satisfies this purpose and means test in the context of prospective legislation may not suffice for retroactive legislation" (Resp. Br. 6). The "retroactive application of the legislation [must] *itself* [be] justified by a rational legislative purpose." *Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 730 (emphasis added). See also *United States* v. *Sperry Corp.*, 493 U.S. at 64. Retroactive application of the 1987 amendment to Section 2057 of the Internal Revenue Code complies with this requirement, for it rationally furthers a valid legislative purpose.

National legislation in general, and tax legislation in particular, is designed to accomplish public objectives. "Taxation is neither a penalty imposed on the taxpayer nor a liability which he assumes by contract. It is but a way of apportioning the cost of government among those who in some measure are privileged to enjoy its benefits."[5] *Welch* v. *Henry*,

dation, et al., Br. 10), no fewer than five voted *in favor* of the challenged legislation. See 133 Cong. Rec. 37,088, 37,712 (1987). Moreover, in a democratic society, the actions of duly elected representatives are not ordinarily thought of as "tyranny," and it is certainly not "tyranny" that the majority, rather than the minority, prevails in our legislative system. It cannot, in any event, reasonably be contended that a curative amendment to an estate tax provision, designed to avoid unintended tax benefits for purely tax-motivated transactions, represents "tyranny" under any plausible definition of that term.

[5] We note, in this context, that respondent's reliance on Contract Clause cases (Resp. Br. 10-12) is inapposite. In *Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 732, the Court expressly rejected the suggestion that it "apply constitutional principles that have been developed under the Contract Clause, Art. I, § 10, Cl. 1 ('No State shall . . . pass any . . . Law impairing the Obligation of Contracts . . .'), when reviewing * * * federal legislation." The Court noted that it has "contrasted the limitations imposed on States by the Contract Clause with the less searching standards imposed on economic legislation by the Due Process Clauses. * * * And, although we have noted that retrospec-

305 U.S. 134, 146 (1938). When Congress makes a mistake in the phrasing of complex tax legislation, and thereafter becomes aware that various individuals may seek to profit at the public expense from this drafting error, it is in the public interest for the mistake to be corrected. This Court has recognized the importance of this public interest by endorsing the "unquestionably valid" power of Congress retroactively to "enact curative statutes" for tax legislation (*Graham & Foster* v. *Goodcell*, 282 U.S. 409, 428 (1931)). See also Pet. Br. 14-17.

The 1987 amendment to Section 2057 was a rational means of accomplishing this valid legislative purpose.[6] Although Section 2057, in its original form, could be read to permit an executor to qualify for a windfall deduction by purchasing securities on the open market and promptly selling them to an ESOP, as occurred here, that reading of the statute was flatly at odds with the fundamental principle that tax legislation does not give effect to transactions that lack any economic motive other than tax avoidance. See, *e.g.*, *Knetsch* v. *United States*, 364 U.S. 361 (1960); *Gregory* v. *Helvering*, 293 U.S. 465, 470 (1935).[7] As Senator Bentsen, then Chair-

tive civil legislation may offend due process if it is 'particularly "harsh and oppressive,"' * * * that standard does not differ from the prohibition against arbitrary and irrational legislation that we clearly enunciated in [*Usery* v. *Turner Elkhorn Mining Co.*]." 467 U.S. at 733.

[6] Because the 1987 amendment is curative, it is not necessary to rely solely on the cases that also recognize that the constitutional authority to lay and collect taxes is sufficient by itself to permit Congress retroactively to impose a "tax by a new statute, although the measure of it was governed by the income of the past year" (*Stockdale* v. *Insurance Cos.*, 87 U.S. (20 Wall.) 323, 331 (1873)). See also *Welch* v. *Henry*, 305 U.S. at 148; Pet. Br. 15-17 nn.11 & 12.

[7] Respondent misses the point in arguing (Resp. Br. 39-40) that tax avoidance is not inherently evil. While a taxpayer has no "patriotic duty" to increase his taxes, the Internal Revenue Code has consistently

man of the Senate Finance Committee, stated in proposing the 1987 legislation, "Congress did not intend for estates to be able to claim the deduction by virtue of purchasing stock in the market and simply reselling the stock to an ESOP" (133 Cong. Rec. 4294 (1987)), and it did not intend to permit a deduction for "essentially sham transactions" (*ibid.*).

While respondent now claims surprise at this congressional concern, it is obvious that, if his imaginative application of the statute had been left uncorrected, the result would have been an unintended and wholesale erosion of the estate tax

been interpreted to afford tax benefits only to transactions that are of economic substance *apart* from tax avoidance. See, *e.g.*, B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 14.51, at 14-170 (5th ed. 1987) ("a transaction should not be given effect for tax purposes unless it serves a purpose other than tax avoidance. Thus, a transaction heavily laden with tax avoidance motives may be disregarded as a sham."). Interpreted as respondent claims he did in 1986, however, Section 2057 would permit tax benefits for purchase-resale transactions performed for no purpose other than tax avoidance. It is the implausibility of such a facial reading of the statute, not the impossibility of such a reading, that underlies our claim that respondent could not reasonably rely on the original terms of the statute to obtain a benefit that appeared "too good to be true" and to create a tax "loophole you could drive a truck through" (A. Murray & J. Birnbaum, *New Loophole May Help Many Beat Estate Tax*, Wall St. J., Dec. 31, 1986, at 17, col. 2).

The potential hazards to respondent's reading of the original version of Section 2057 may not have completely escaped his attention during 1986. Evidently recognizing that a profit or business motive is required before a transaction is recognized for tax purposes, respondent claims that he did not prearrange a sale to the ESOP of the securities he purchased in the open market. By holding the stock for two days before the sale to the ESOP was made, the estate asserts that it took an economic risk that the price of the stock would rise or fall in the interim (Resp. Br. 38). By contrast, in *Ferman* v. *United States*, 993 F.2d 485 (5th Cir. 1993), petition for writ of certiorari pending, No. 93-569, the executor prearranged the ESOP sales and executed those sales on the same day that she purchased stock for the estate in the open market.

base and a staggering revenue loss. As financial observers noted during the same month that respondent's transaction occurred, "[t]his is the loophole you could drive a truck through" (A. Murray & J. Birnbaum, *New Loophole May Help Many Beat Estate Tax*, Wall St. J., Dec. 31, 1986, at 17, col. 2). Judge Norris accurately observed in dissent in this case that "the statute on its face offered a benefit that appeared 'too good to be true' " (Pet. App. 34a).[8] As eminent tax counselors have cautioned their profession, "the lawyer's passion for technical analysis of the statutory language should always be diluted by distrust of a result that is too good to be true." B. Bittker & J. Eustice, *supra*, ¶ 14.51, at 14-170.

[8] Respondent argues (Resp. Br. 14-20) that, when viewed in the context of the generous tax incentives that Congress has created to encourage employers to maintain ESOPs, his asserted reliance on the facially unlimited scope of Section 2057 was reasonable. When compared to the incentives afforded by other ESOP provisions, however, the congressional largess that respondent attributes to Section 2057 is dramatically greater. No other ESOP provision affords a taxpayer an opportunity completely to avoid his entire tax liability while guaranteeing no certain benefit to the Plan. Section 133 of the Code, to which respondent compares Section 2057 (Resp. Br. 18-19 nn.21, 22), allows banks to exclude 50% of interest income received from loans made to ESOPs. The result is that, "[a]t a ten percent interest rate, every nickel of tax base the Treasury loses lands a dollar in the pocket of an ESOP" (Pet. App. 35a (Norris, J., dissenting)). Under respondent's approach to Section 2057, however, the statute would permit an estate completely to remove its entire value from the reach of the tax. By engaging in a series of sham transactions, and deducting one-half of the sales prices of those transactions in calculating its taxable estate, the estate could escape tax entirely. As discussed in our opening brief, the interpretation that respondent claims he placed on the initial statute would cost the United States several times *more* in lost tax revenues than if it simply paid a "discount" for ESOP open market purchases directly to the ESOP itself. See Pet. Br. 27 n.19.

Congress has an unquestionably valid interest in correcting egregious and unintended "loopholes" in revenue legislation. In amending Section 2057 to make express that it did not encompass the unprecedented windfall that respondent seeks, Congress did no more than confirm the rational expectation that the statute was not intended to permit wholesale, facile evasions of the estate tax by imaginative executors.[9] And, by prospectively amending the statute to impose this same requirement for post-1986 transactions, Congress ensured that its retroactive amendment of Section 2057 did not give "[a] more oppressive legal effect to conduct undertaken before enactment of the statute." *United States* v. *Hemme*, 476 U.S. 558, 569 (1986).[10]

[9] Respondent unconvincingly asserts (Resp. Br. 23) that he gained no understanding of the congressional intent to limit the benefit of Section 2057 to estates of individuals who owned the securities during their lifetimes from the original legislative history of that provision. That history included at least two descriptions of the statute as making available to ESOPs from the estates of shareholders a pool of stock that otherwise might not be available for sale to plan trustees. See Pet. Br. 27 n.19. Stock purchased after the decedent's death on the open market—as in this case—obviously does not fall within those descriptions of the statute. To be sure, as respondent points out (Resp. Br. 23), these legislative references highlight a class of decedent owners without expressly limiting the deduction to that class. But, as Judge Norris noted in dissent, if "Congress had meant to allow any estate willing to undertake a relatively low-risk securities transaction to benefit from the ESOP proceeds deduction, then examples of decedent owners selling to their employees would be an infinitesimal proportion, not a prototypical example, of the beneficiaries of the rule" (Pet. App. 34a). See also note 7, *supra*.

[10] In addition to imposing the decedent-ownership requirement, the complementary prospective amendment to Section 2057 also imposed requirements for the deduction for post-February 1987 transactions that are not applicable to pre-February 1987 transactions. See Resp. Br. 40-41.

The curative amendment that Congress adopted was a rational means of implementing this valid legislative purpose. By limiting the availability of the Section 2057 deduction to estates of decedents who owned the securities at the time of death, the 1987 amendment was made retroactive for "only that * * * period that Congress believed would be necessary to accomplish its purposes" (*Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 731). By making the curative legislation retroactive to October 1986, when Section 2057 was originally enacted, the statute provides a uniform rule for all estates to which the deduction is available. It did not deny the benefits of the deduction to any estate that made a sale of securities that the decedent owned at death. The retroactive (and prospective) amendment merely forestalls evisceration of the estate tax by the abusive use of Section 2057 to claim deductions for tax motivated, "essentially sham transactions" of the type in which respondent engaged.

3. Respondent errs in attempting to distinguish on their facts the numerous decisions of this Court that have upheld retroactive taxes and in contending that "actual or constructive notice" of a legislative enactment must, in every instance, precede its effective date (Resp. Br. 27-37). That contention is refuted by both early and modern holdings of this Court. In *Stockdale* v. *Insurance Cos.*, 87 U.S. (20 Wall.) 323 (1873), for example, the Court held that Congress could retroactively impose a "tax by a new statute, although the measure of it was governed by the income of the past year." *Id.* at 331. Similarly, in *Welch* v. *Henry*, 305 U.S. 134 (1938), the Court upheld the retroactive imposition of a state tax on dividends received in the year preceding the enactment even though no advance "notice" of the legislation existed. In upholding the retroactive state tax, the Court observed that Congress frequently enacts income tax laws that "redistribute[ ] retroactively the tax burdens imposed by preexisting laws." *Id.* at 148. In *Usery* v. *Turner Elkhorn Mining Co.*, in holding that retroactive legislation is not unconstitutional merely because it "upsets otherwise settled expectations" and "impose[s] a new duty or liability based on past acts" (428 U.S. at 16), the Court directly rejected a constitutional "notice" requirement of the type that respondent proposes.

Courts have repeatedly rejected the suggestion that new legislation may not constitutionally be applied to transactions that occurred without actual or constructive notice of its pending enactment. See Pet. Br. 20-24. Congress is frequently called upon to make "retroactive revisions of the federal * * * revenue laws" and, in doing so, "impose[ ] taxes on subjects previously untaxed and shift[ ] the burden of old taxes by changes in rates, exemptions and deductions" (*Welch* v. *Henry*, 305 U.S. at 145). Every taxpayer "should be regarded as taking his chances of any increase in the tax burden which might result from carrying out the established policy of taxation." *Milliken* v. *United States*, 283 U.S. 15, 23 (1931). In a conclusion that applies directly to this case, the Court has held that a taxpayer can not "justly assert surprise" or claim immunity from tax burdens when Congress retroactively adjusts prior tax legislation in light of experience "at the first opportunity after knowledge of the nature and amount of the income is available." *Welch* v. *Henry*, 305 U.S. at 150. See also Pet. Br. 20-24.[11]

4. Respondent asserts (Resp. Br. 34) that, because his transactions were purely tax motivated, he would not have

[11] In *United States* v. *Darusmont*, 449 U.S. 292 (1981), the Court noted that, "[i]n enacting general revenue statutes, Congress almost without exception has given each such statute an effective date prior to the date of actual enactment." *Id.* at 296. The Court stated that, "to challenge the * * * tax it is not enough to point out that the taxable event, the receipt of income, antedated the statute." *Id.* at 298, quoting *Welch* v. *Henry*, 305 U.S. at 147.

engaged in the purchases of stock in December 1986 but for his expectation that he would qualify for the Section 2057 deduction. He contends that Congress should not retroactively "deprive[ ] a citizen of a benefit that the government used to induce that citizen to behave in a particular way" (Resp. Br. 10). That contention, of course, directly conflicts with this Court's conclusion that retroactive legislation is not invalid merely because it "upsets otherwise settled expectations" (*Usery* v. *Turner Elkhorn Mining Co.*, 428 U.S. at 16). It also confuses public legislation with private contracts.

Legislation is not a promise and taxpayers have no vested right in the Internal Revenue Code. As this Court has noted on several occasions (*United States* v. *Darusmont*, 449 U.S. at 298, quoting *Welch* v. *Henry*, 305 U.S. at 146-147):

> Taxation is neither a penalty imposed on the taxpayer nor a liability which he assumes by contract. It is but a way of apportioning the cost of government among those who in some measure are privileged to enjoy its benefits and must bear its burdens. Since no citizen enjoys immunity from that burden, its retroactive imposition does not necessarily infringe due process * * *.

Legislation seeks to accomplish public objectives through generally applicable standards. When Congress makes a mistake in the phrasing of its legislation, it is in the public interest for that mistake to be corrected. The legislative power to give retroactive effect to curative tax legislation is most compelling when, as here, a matter of legislative grace, such as a deduction, exemption or other privilege, is at stake. See *Miller* v. *Commissioner*, 115 F.2d 479, 480 (9th Cir. 1940), cert. denied, 312 U.S. 703 (1941). There is an "unquestionably valid" power in Congress to "enact curative statutes" to perfect the terms and conditions under which public revenues are assessed and collected (*Graham & Foster* v. *Goodcell*, 282 U.S. at 428).

In this case, as in *Welch* v. *Henry*, 305 U.S. at 150 (upholding application of a new state tax to "the receipt of income during the year * * * preceding that of its enactment"), the taxpayer asserts that his conduct would have differed if he had been aware at the outset of the legislative revisions thereafter enacted.[12] In *Welch*, the Court rejected the claim that the Constitution protects taxpayers from "the particular inconvenience * * * in being called upon * * * to bear a governmental burden of which it is said he had no warning and which he did not anticipate." *Welch* v. *Henry*, 305 U.S. at 148. "Assuming that a tax may attempt to reach events so far in the past as to render that objection valid, * * * no such case is presented here," for "taxpayers can[not] justly assert surprise or complain of arbitrary action in the retroactive apportionment of tax burdens to income at the first opportunity after knowledge of the nature and amount of the income is available." *Id.* at 150.

Moreover, as discussed in our opening brief (Br. 4 n.6 & 28), it is the economic risk associated with the timing of respondent's transaction, not the inducement of "the benefit of the Section 2057 deduction" (Resp. Br. 14), to which the estate's loss in this case is most directly attributable. Respondent does not dispute that, if he had engaged in the same transaction only a few days earlier, the estate would have realized a sizeable profit instead of a loss from the transaction. See Pet. Br. 4 n.6.[13] It was the timing of respondent's

[12] In *Welch*, the Wisconsin legislature retroactively imposed a tax on dividends received from Wisconsin corporations, for which the State previously had allowed a deduction on individual income tax returns. The taxpayer in *Welch*, like the taxpayer here, asserted that this retroactive change in the tax treatment of his completed financial transactions represented a deprivation of vested property rights without "due process of law." 305 U.S. at 141.

[13] The tax effects of the estate's "loss" from the purchase and sale of the MCI stock are not at issue in this case. If a profit or business motive

purchases, not the inevitable application of the statute, that produced the "loss" for the estate. And, whether respondent realized a "loss" or a "gain" from the transaction, in either situation the amount of the claimed deduction under Section 2057 would be the same. *Ibid.*

Under the theory of the court of appeals, however, the "loss" incurred by the estate in this particular transaction played a dispositive role (Pet. App. 19a). Under the "detrimental reliance" rationale of the court of appeals, the retroactive amendment to Section 2057 would evidently have been constitutional if respondent had purchased the MCI stock on December 3, 1986, instead of on December 10, 1986, for respondent would then have no "detriment" of which to complain. See Pet. Br. 4 n.6. There is no precedent for such wavering constitutional guidelines for retroactive legislation. Instead, under this Court's prior holdings, the 1987 amendment satisfies the requirements of due process because it represents a rational means of accomplishing Congress's "unquestionably valid" purpose of promptly curing acknowledged defects in the drafting of complex tax legislation.

The judgment of the court of appeals should be reversed.

Respectfully submitted.

DREW S. DAYS, III
Solicitor General

JANUARY 1994

existed for the estate's transaction, respondent may be able to establish a basis for an income tax deduction for that loss. See 26 U.S.C. 165. In this case, however, only the estate tax deduction (for one-half of the sale proceeds) under Section 2057 is at issue.

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No. 92-1941

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OCTOBER TERM, 1993

THE UNITED STATES OF AMERICA

Petitioner,

v.

JERRY W. CARLTON,

Respondent.

On Writ Of Certiorari
To The United States Court of Appeals
For The Ninth Circuit

MOTION FOR LEAVE TO FILE A BRIEF AS AMICUS CURIAE AND BRIEF OF THE AMERICAN CAUSE AS AMICUS CURIAE IN SUPPORT OF RESPONDENT

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MOTION OF THE AMERICAN CAUSE FOR LEAVE TO FILE A BRIEF AS *AMICUS CURIAE*

The American Cause respectfully moves this Court for permission to file a brief as *amicus curiae* in support of the respondent in this case.

Pursuant to Supreme Court Rule 37.2, The American Cause sought written consent of all parties to the filing of this brief. Although the petitioner granted such consent, the respondent declined to grant consent. On November 11, 1993, Russell G. Allen, counsel for Respondent Jerry W. Carlton, informed Michael J. George, General Counsel to The American Cause, that he would not give consent to The American Cause to file an *amicus brief.* On December 8, 1993, *amicus* sought consent from the Solicitor General of the United States to the filing of an *amicus* brief. On December 9, 1993 the Solicitor General,

Drew S. Days, III, granted such consent. In the absence of consent from both parties, *amicus* must file this motion with the Court.

Amicus respectfully submits that there are compelling reasons for the Court to grant this motion. As the statement of interest in the attached proposed brief explains, The American Cause is a foundation with a national scope of activities and support, dedicated to constitutional and limited government. Recently, as a part of its activities, The American Cause has focused its attention on the retroactive provisions of the tax laws enacted in the most recent session of Congress and, particularly, the provisions retroactively raising federal estate taxes. As a result, the *amicus* has a significant interest in the issues before the Court in this matter.

Amicus seeks leave of the Court to file this brief in order to bring to the Court's attention certain issues which are not addressed in petitioner's brief and are not likely to appear in respondent's brief.

First, *amicus* points out that this Court and the lower courts have acknowledged that some degree of foreseeability of the future enactment of tax legislation is required for retroactive laws to meet the constitutional requirements of due process. This has led to the formulation of various standards concerning the type of notice of legislative changes in the tax law that might support retroactivity. Unfortunately, there is no uniformity in the decided cases as to what standard should apply. While The American Cause believes that retroactive tax laws, in general, should be held unconstitutional as a violation of due process, if this Court will not adopt such a rule, it nevertheless should provide guidance as to the standard that should be applied in cases involving retroactive tax legislation.

Second, The American Cause believes that the instant case presents the Court with an opportunity to draw a clear distinction between the tests that should be applied when considering the constitutionality of prospective and retrospective legislation. Because retrospective legislation has a much harsher effect on citizens, it should be subjected to a heightened degree of scrutiny.

Third, The American Cause urges the Court to reexamine due process as it pertains to retroactive legislation involving property rights. Over the years, this Court and the lower courts have found constitutional protection for civil or non-economic rights while, at the same time, granting less protection to property rights which are explicitly covered by the guarantees of the Fifth Amendment. The deference that has been accorded to retroactive economic legislation does not comport with the original intent of the Framers of the Constitution.

Finally, the *amicus* emphasizes that it has been active in opposing retroactive tax laws and has an interest in insuring that its views as to the correct application of the Constitution to such laws are heard and considered.

The brief that the *amicus* seeks to file thus supplements but does not duplicate the petition and the other briefs submitted. *Amicus* believes the brief will materially assist the Court in its review.

Accordingly, *amicus* respectfully requests that the Court grant its motion for leave to file a brief as *amicus curiae* in support of the petition.

Respectfully submitted,

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QUESTIONS PRESENTED

I. What degree of unforseeability is necessary to trigger operation of the Fifth Amendment's due process protection?

II. Is the imposition of a retroactive additional estate tax as a means of maximizing revenue an arbitrary and capricious legislative act offending the Fifth Amendment's guarantee of due process?

III. Does the deference granted to retroactive tax legislation destroy the meaning and intent of the Fifth Amendment's due process clause?

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BRIEF OF THE AMERICAN CAUSE AS AMICUS CURIAE IN SUPPORT OF RESPONDENT

INTEREST OF THE *AMICUS CURIAE*

The American Cause is a foundation, with a national scope of activities and support, devoted to the Constitution and the concept of limited government. In its short history, The American Cause has been active in expressing this devotion and advocating means by which limited government can be achieved. Most recently, The American Cause has been involved in efforts to counteract the retroactive provisions of the tax bill passed during the just completed session of Congress. Among the retroactive provisions upon which The American Cause has focused is one involving the federal estate tax. Because the Court's decision in this case is likely to have a significant impact on The American Cause's efforts, *amicus*

wishes to present its views on the appropriate constitutional analysis that should be applied to retroactive tax legislation.

SUMMARY OF THE ARGUMENT

Due process requires that laws be knowable. Decisions made by this Court and lower courts have acknowledged this principle by holding that some degree of foreseeability is required such as constructive or actual notice of the probable future enactment of a particular tax law. The cases, concerning when a retroactive legislative change in the law should have been foreseeable and what legislative or other action will suffice to provide the citizenry with adequate notice of an impending change in the tax laws, have resulted in widely disparate holdings. The Court should take the opportunity, presented by this case, to provide needed guidance as to the standards of foreseeability and adequate notice that should be applied in analyzing the constitutionality of retroactive tax legislation.

This Court has acknowledged that prospective and retrospective legislation should be subjected to different standards of review. Because retrospective laws tend to upset settled expectations, and prospective laws do not, retrospective laws should be disfavored. The mere desire to increase revenue to the general fund is not sufficient to justify the imposition of a retroactive tax and such a tax is thus "harsh and oppressive." It is neither exceptional nor significant that a tax law is motivated by a desire to merely increase revenue for the general fund. All tax legislation shares this omnipresent motivation. Absent exceptional or significant special circumstances, any tax law which disturbs settled expectations should be viewed as harsh and oppressive.

The two standards of review applied in the analysis of retroactive economic legislation have combined to virtually end serious constitutional consideration of such legislation, particularly tax legislation. The "general deference" standard applied

to economic legislation examines only the legitimacy of the legislative end and the rationality of the mechanism employed. The "tax deference" standard modifies the general deference standard by delaying scrutiny until after the nature of the tax and the circumstances in which it is laid is considered. Only after these are considered can a determination be made whether a tax is so harsh and oppressive as to offend the Constitution.

In the case at hand, fundamental rights respecting property were impacted by the retroactive application of a statute. This should trigger heightened scrutiny on review as it would if a non-economic civil right were so impacted. Given that the rights of citizens respecting property were of great importance to the Framers of the Constitution, the current trend towards zealously protecting social rights and abandoning efforts to protect constitutionally important economic rights desiccates the purposes and meaning of a large part of the Constitution and is not in accord with the prevailing view, at the time of ratification of the Constitution, that all rights protected by the Constitution were sacred.

ARGUMENT

I. What degree of unforeseeability is necessary to trigger operation of the Fifth Amendment's due process protection?

Benjamin Cardozo commented in *The Growth of the Law*, "Law as a guide to conduct is reduced to the level of futility if it is unknown and unknowable."[1] Decisions made by this Court and lower courts have acknowledged this due process[2] principle either implicitly or explicitly in holding that some degree of

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[1] B. Cardozo, *The Growth of the Law* 3 (1924).

[2] According to Professor Corwin, the term "due process of law" comes from chapter 3 of 28 Edw. III (1335), which states: "No man of what state or condition he be, shall be put out of his lands or tenements nor taken, nor

foreseeability, such as constructive or actual notice, of the probable future enactment of a particular tax law is necessary to excuse or justify the retrospective action of such laws.[3]

The American Cause maintains that the only appropriate and constitutionally permissible test of foreseeability should turn on the date of the enactment of tax legislation; *i.e.*, tax legislation should only be granted prospective effect. At a minimum, if tax legislation is to be permitted to have retroactive effect, it should not be permitted to do so on a date earlier than that on which the legislation was introduced. The American Cause recognizes that its interpretation of the mandates of the Constitution are not currently embraced by this Court, nor are its beliefs as to the appropriate standard for assessing foreseeability. There is, nevertheless, a need for this Court to reexamine the concepts of foreseeability and appropriate notice under the Due Process clause.

Despite the general acceptance of the concept of foreseeability, referred to hereinafter as the "notice doctrine," the application of the concept has been inconsistent, even in similar cases. In *Blodgett v. Holden*,[4] and *Estate of Ceppi v. Commissioner*,[5] introduction of a bill in the legislature was deemed to be adequate notice and sufficient for due process. Some deci-

disinherited, nor put to death, without he be brought to answer by due process of law." This statute, in turn, has as its distinguished ancestor the Magna Carta's requirement that a free man be treated by the King and his agents in accordance with the law of the land (*per legem terrae*). Corwin, *The Constitution And What It Means Today*, 326 (13th ed. 1973).

[3] See, generally, *United States v. Darusmont*, 449 U.S. 292 (1981); *Welch v. Henry*, 305 U.S. 134 (1938); *Milliken v. United States*, 283 U.S. 15 (1931); *Untermyer v. Anderson*, 276 U.S. 440 (1928); *Fein v. United States*, 730 F.2d 1211 (8th Cir. 1984); *Estate of Ceppi v. Commissioner*, 698 F.2d 17 (1st Cir. 1983); *Buttke v. Commissioner*, 625 F.2d 202 (8th Cir. 1980); *Purvis v. United States*, 501 F.2d 311 (9th Cir. 1974).

[4] 275 U.S. 142 (1928)

[5] 698 F.2d 17 (1st Cir. 1983).

sions were based upon a more liberal understanding of what constituted adequate notice. *Welch v. Henry*,[6] *United States v. Hudson*,[7] and *Miller v. Commissioner*[8] posited that, essentially, all citizens were on notice that tax laws could change and therefore any reasonable period of retroactivity was constitutionally inoffensive. At least one decision seems to stand for the proposition that any conceivable activity pertaining to possible or prospective legislation is sufficient to provide notice, even if the activity is outside of the legislature. *Purvis v. United States*.[9]

These notice doctrine cases, although all based upon the well settled proposition that citizens should have some hope of knowing what the law is, express divergent views on just what degree of foreseeability is necessary to guarantee due process. The result is that multiple and often conflicting standards are applied. The ensuing confusion renders the standard itself as unknowable as the legislation in question.

Furthermore, the notice doctrine is fundamentally flawed. Should two laws both be proposed, one imposing an additional tax on a particular economic activity and one reducing the tax on the same activity, the economically active and legislatively aware citizen is placed squarely on the very sharp horns of a dilemma. Obviously, there is no way such a citizen can be justly said to be apprised of anything. As was stated in *Untermyer*, such a view

> "would produce insuperable difficulties touching interpretation and practical application of the statute and render impossible proper understanding of the burden intended to be imposed. The taxpayer may justly

[6] 305 U.S. 134 (1938).

[7] 299 U.S. 498 (1937).

[8] 115 F.2d 479 (9th Cir. 1940).

[9] 501 F.2d 311 (9th Cir. 1974).

> demand to know when and how he becomes liable for taxes — he cannot foresee and ought not to be required to guess the outcome of pending measures. The future of every bill while before Congress is necessarily uncertain. The will of the lawmakers is not definitely expressed until final action thereon has been taken."[10]

Indeed, the more likely scenario is that scores of conflicting laws will be proposed by any number of participants in that confused maelstrom known as the legislative process. Even if we assume, *arguendo*, that a taxpayer has the means and intestinal fortitude to decipher the meaning and effect of these numerous proposals, the taxpayer is reduced to the role of a handicapper: forced to place bets, with his economic well-being at stake, over which of a multitude of proposed laws will cross the finish line first. Absent a gift of prescience, the taxpayer is no better off with such "notice" than without it.

Complicating the notice doctrine even further is the rule regarding wholly new taxes.[11] Presumably, any tax which is not wholly new is foreseeable to some extent depending upon which of the foregoing standards of notice is chosen. Consequently, wholly new taxes would presumably receive greater scrutiny and be more likely to offend due process.[12] Although a new law imposing additional burdens upon a citizen would commonly be thought to be a new tax, the wholly new tax rule strictly construes the meaning of the phrase "wholly new tax" so as to include only legislation which taxes an entirely new class of

[10] *Untermyer v. Anderson*, 276 U.S. 440, 445-446 (1928).

[11] See generally, *Nichols v. Coolidge*, 274 U.S. 531 (1927); *Untermyer v. Anderson*, 276 U.S. 440 (1928).

[12] *Milliken v. United States*, 283 U.S. 15 (1931); *Fein v. United States*, 730 F.2d 121 (8th Cir. 1984); *Estate of Ceppi v. Commissioner*, 698 F.2d 17 (1st Cir. 1983); *Buttke v. Commissioner*, 625 F.2d 202 (8th Cir. 1980); *Purvis v. United States*, 501 F.2d 311 (9th Cir. 1974).

economic activity.[13] All other taxes, being mere changes of effect rather than of class, are excluded from the greater scrutiny suggested by the rule.

Although the rule seems relatively well ensconced in constitutional thought regarding tax legislation[14], construction of the rule in application ignores the practical effect of a change in tax structure. It is cold comfort to the citizen, whose taxes ratchet up due to a legislative decision to retroactively tax some activity at a much higher rate, that the tax is not "wholly new." Insofar as the tax creates additional burdens and affects the citizen's economic well-being, the tax is wholly new in its practical effect upon individual taxpayers. This exceedingly strict construction of the term "wholly new" robs it of practical meaning and eviscerates what might otherwise be a bulwark against legislative abuse. If accepted as controlling law, the common practice of strictly construing "wholly new" merely stands for the proposition that the confusingly inconsistent notice doctrine discussed *supra* be applied to all tax legislation. Until or unless Congress enacts a tax on a heretofore untaxed sphere of activity (*e.g.*, a sales or value added tax) the rule has no application and the entirety of tax legislation is to be governed by the notice doctrine without moderation by the wholly new tax rule.

At their core, both the notice doctrine and the wholly new tax rule, are attempts to provide some means of ensuring that citizens are able to know the law and are judicial acknowledgements that foreseeability of a new retroactive law is constitutionally desirable. Clearly, the ability of a citizen to know the law is fundamental to the concept of due process.[15] However, as noted in the preceding discussion, the multifaceted and inter-

[13] *Milliken v. United States*, 283 U.S. 15 (1931).

[14] See notes 11-12, *supra*.

[15] B. Cardozo, *The Growth of the Law* 3 (1924).

nally conflicted notice doctrine fails in providing an adequate structural safeguard and flounders in its attempt to protect the individual citizen from the danger of unforeseeability. Similarly, the wholly new tax rule is almost useless as a safeguard in that it has virtually no practical application as commonly construed. The inadequacy of the current and lamentable state of foreseeability as a constitutional restriction on legislative action is clear. Despite its constitutional necessity, foreseeability as it pertains to legislative enactments of retroactive economic laws is a toothless tiger.

The *amicus curiae* The American Cause urges the Court to redress the currently disarrayed area of foreseeability. In the case at hand, the Respondent could not predict the subsequent legislative enactment and should not be required to do so. The Court is now provided with the opportunity to settle the disturbed and murky waters surrounding the issue of foreseeability.

II. Does the imposition of a retroactive additional estate tax as a means of maximizing revenue offend the Fifth Amendment's guarantee of due process?

A. Constitutional Examination of Retroactive Laws Must be Harsher than of Prospective Laws.

It is well established that the legislature cannot act arbitrarily, capriciously, irrationally or in furtherance of non-legitimate legislative ends.[16] Nor can the legislature, in light of the circumstances, act in a harsh or oppressive manner.[17] It is less well established what many of the above terms mean.

The raising of revenue is certainly a legitimate legislative end. Obviously, no government could function for long without

[16] *United States v. Sperry*, 493 U.S. 52 (1989); *Pension Benefit Guaranty Corp v. R.A. Gray*, 467 U.S. 717 (1984); *Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1 (1976).

[17] *United States v. Darusmont*, 446 U.S. 292 (1981); *United States v. Hemme*, 476 U.S. 558 (1986).

some mechanism for raising revenue. However, the means by which revenue is raised is subject to abuse and for that reason the Fifth Amendment guarantees that no one be deprived of life, liberty or *property* without due process of law.[18] It is the means by which the government obtains property that is the central concern of constitutional due process scrutiny and it is the means employed by the government that is the central issue in the instant case.

Here, the government, by retrospective legislation, deprived the Respondent of a tax deduction upon which he relied to his detriment by engaging in a transaction through which he lost over six-hundred thousand dollars.[19] The government, it is well established,[20] had as its sole reason for enacting this retrospective law a desire to maximize its revenue. No suggestion of a national emergency or other lesser but important reason is noted in the pleadings. The legislature's enactment was motivated merely by a desire to secure for the general fund adequate revenue.

In examining the facts of the case at hand, it becomes apparent that the means employed, a retroactive tax, should be examined with some skepticism. The government does not argue convincingly that prospective legislation would be inadequate to raise the required funds. Simply put, the government need not have made the statute in question retroactive since it could have accomplished this goal, raising revenue, prospectively. Although there is some authority which stands for the proposition that no essential difference exists from a constitutional standpoint between retrospective and prospective laws,[21]

[18] U.S. Const., amend. V.

[19] Brief for the United States at 4n.6.

[20] *Id.* at 5-6.

[21] *Stockdale v. Atlantic Ins. Co.*, 87 U.S. 348 (20 Wall. 323) (1874). Congress may pass a retroactive law if the purpose is clear and that purpose is within the power of Congress.

this proposition has clearly not withstood the test of time and the more convincing authority is the more recent. In *Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1, 16-17 (1976) this Court stated:

> "It does not follow, however, that what Congress can legislate prospectively it can legislate retrospectively. The retrospective aspects of legislation, as well as prospective aspects, must meet the test of due process, and the justifications for the latter may not suffice for the former."

Based upon the language in *Usery, supra*, it seems an obvious conclusion that retrospective legislation should be subject to harsher scrutiny than prospective legislation. *Id.* It thus logically follows that, where one variety of legislation is favored constitutionally over another, the disfavored legislation should be accompanied by, at a minimum, special and additional circumstances making the disfavored legislation acceptable to due process scrutiny. Such circumstances need not necessarily rise to the level of a national emergency, but something more than the omnipresent need to raise revenue should be required.[22]

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[22] The possibilities abound as to what might constitute special circumstances. One such is the "curative effect" of the legislation. Where legislation contains a non-substantive error, and correction of such an error does not necessarily change the effect of the law (*e.g.*, a change to bring the clear meaning in accord with judicially interpreted meaning), special circumstances can be said to exist. *Wiggins v. Commissioner*, 904 F.2d 311 (5th Cir. 1990) concerns such curative purpose. *Id.* citing *Canisius College v. United States*, 799 F.2d 18, 27 (2nd Cir. 1986) cert. denied 481 U.S. 1014 (1987): "Where legislation is curative, retroactive application may be constitutional despite a long period [4 years] of retroactivity." *Wiggins*, citing *Fife v. Commissioner*, 82 T.C. 1 (1984): "Congress's intention in enacting the new provision was to clarify existing law, not to change the law." Of course, the strongest compelling interest is an emergency such as war; in *Lichter v. U.S.*, 334 U.S. 742 (1948), the government was allowed to renegotiate contracts to prevent profiteering.

The facts of this case reveal no compelling special circumstances so as to justify the choice of a retrospective over a prospective tax mechanism. The sole motivation for the enactment was concern by the legislature for maximizing revenue after Congress' realization that the 1986 amendment would lose more revenue than predicted at the time it was enacted. Clearly, such an end could have been achieved by prospective legislation. Absent special and compelling circumstances, the law as expressed in *Usery, supra*, requires an elevated level of scrutiny of the enactment. Simply wanting to increase funds is insufficient as a special circumstance for the obvious reason that all tax laws have as their purpose the raising of revenue. The contrary view renders the language of this Court in *Usery* mere surplusage without effect or meaning.

The *amicus* The American Cause urges this Court to correct the misunderstanding of *Usery* and enunciate a final and clear exposition of the proposition that retrospective legislation must by constitutional necessity be disfavored if prospective legislation is adequate to achieve the legitimate legislative end of raising revenue.

B. Imposing a Retroactive Tax Merely to Raise Revenue is Unduly Harsh and Oppressive.

The government argues, citing *Nebbia v. New York*, 291 U.S. 502, 525 (1934), that respecting legislation by the Congress in commercial matters, the Fifth Amendment's guarantee of due process requires only that "the law shall not be unreasonable, arbitrary and capricious, and that the means selected shall have a real and substantial relation to the object sought to be obtained."[23] Indeed, the government goes on to point out that this Court has stated even more forcefully[24] in *Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*, 467 U.S. at 729:

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[23] Brief for the United States at 12.

[24] *Id.*

"[T]he strong deference accorded legislation in the field of national economic policy is no less applicable when that legislation is applied retroactively. Provided that the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches."

The government thus restates the proposition that the judicial branch, in examining economic legislation for compliance with the Fifth Amendment's due process clause, need only examine whether legislation is rationally designed to accomplish a legitimate legislative purpose.[25] Under the current standard, economic legislation which has a retroactive effect is subject to a level of scrutiny identical to that used to examine any enactment, retroactive or not. Thus, as above, so long as the government can show that the retroactivity of the legislation is supported by: (1) a legitimate legislative purpose; and this purpose is achieved by (2) rational means; the retrospective law will not offend the Fifth Amendment's due process clause.

In matters concerning tax legislation, the standard of review is, on its face, an even milder level of scrutiny.[26] The nature of a retroactive tax and the circumstances surrounding its enactment are first examined.[27] Only after taking these factors into consideration may the next step be performed, a determination if the legislation's effect is so harsh, in light of the statute's

[25] *Id.*

[26] *United States v. Hemme*, 476 U.S. 558 (1986); *United States v. Darusmont*, 446 U.S. 292 (1981); *Welch v. Henry*, 305 U.S. 134 (1938). In *Hemme*, the most recent case, this Court restated the rule expressed earlier in *Welch*: "[W]e must 'consider the nature of the tax and the circumstances in which it is laid before it can be said that its retroactive application is so harsh and oppressive as to transgress the constitutional limitation.'" at 568-569.

[27] *Id.*

nature and circumstances, as to transgress the Constitution.[28] This test presumably allows a law which may be deemed unduly harsh and oppressive so as to offend due process to survive if there is a good enough reason for the law — such a standard may also be termed the "good excuse" standard.

In the case at hand; the Respondent reviewed the law and made irrevocable decisions based upon a sound understanding of that law.[29] Subsequent to those decisions, the law was changed retroactively.[30] The government now argues that this change in the existing law was not unduly harsh and oppressive since it was justified by the good excuse of revenue maximization. The American Cause suggests to the Court that merely desiring to increase revenue to the general fund is not a meaningful "special circumstance" and is thus an insufficient excuse to justify the imposition of a retroactive tax.

Under the standard expressed in *Hemme*,[31] scrutiny of the effects of the new law is to be done only after an evaluation of the nature and circumstances of the tax are taken into consideration. As previously discussed, since all tax laws have as their goal and motivation the raising of revenue, this is not a "circumstance" worthy of significant consideration. No exceptional or peculiar circumstances are present where the legislative desire is merely to increase revenue for the general fund. As a consequence, any reliance upon existing law which is disturbed by a subsequent retrospective legislative act should be viewed as harsh and oppressive where the injured party changed position in detrimental reliance on the existing law. Such a view is in accord with the standard most recently enunciated in *Hemme*.[32]

[28] *Id.*

[29] Respondent's Brief in Opposition at 3.

[30] Brief for the United States at 6.

[31] See note 26, *supra*.

[32] *United States v. Hemme*, 476 U.S. 558 (1986).

The *amicus* The American Cause therefore urges the Court to provide specific guidance regarding the extent of scrutiny required of retrospective tax legislation and clarify the meaning of its directive to consider the nature and circumstances of a retrospective tax.

III. Does the deference granted to retroactive tax legislation destroy the meaning and intent of the Fifth Amendment's due process clause?

A. Judicial Abdication in the Field of Retroactive Economic Legislation Does Not Serve the Constitution.

It has been pointed out that two standards of review apply to retroactive economic legislation.[33] These are the doctrines of "general deference" and "tax deference."[34] General deference is the standard wherein a legislative act respecting economic policy shall be examined only for the legitimacy of its end and for the rational basis of its mechanism.[35] Tax deference is the standard that legislative acts in the economic field shall only be subject to scrutiny after the nature of the tax and the circumstances in which it is laid is considered prior to examining whether the tax is so harsh and oppressive as to offend the Constitution.[36] These two doctrines in combined application represent a virtual abandonment of the field of Constitutional review of economic legislation, particularly of tax legislation.[37]

[33] Note, *Has Due Process Struck Out?*, 42 Duke L.J. 1069, 1070.

[34] *Id.* at 1070.

[35] *Id.*

[36] *Id.*

[37] See, e.g., *United States v. Sperry*, 493 U.S. 52 (1989); *Pension Benefit Guaranty Corp v. R.A. Gray & Co.*, 467 U.S. 717 (1984); *Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1 (1976). These cases, despite the cautionary language, have come to be interpreted as judicial deference for retroactive economic laws. This judicial doctrine represents a departure from the historic hostility to retroactive enactments by the legislature.

This abdication is all the more surprising and disappointing given the traditional and historical hostility to retroactive legislation which is deeply embedded in our jurisprudence.[38]

The *amicus curiae*, The American Cause, believes that such an abdication, if true, would be a sad commentary on the vitality of the Constitution and of the due process clause in particular. As Justice Story stated, "Retrospective laws are . . . generally unjust; and . . . neither accord with sound legislation nor with the fundamental principles of the social compact."[39]

If the Constitution cannot reach legislative enactments which are, as Justice Story noted, "generally unjust" what does the phrase "due process" mean? The American Cause asserts that the Constitution's guarantee of due process cannot embrace "generally unjust" laws. The American Cause thus urges the Court to reconsider the direction of the evolving due process doctrine and overrule such decisions as exist which embrace generally unjust retrospective laws. The American Cause asks that the Court re-examine the original intent of the Framers and make a clear statement that our Constitution does not tolerate retroactive laws. The *amicus* submits that should the existing and long line of cases be allowed to stand without such action by the Court, due process will continue to lose its force as a limitation on government actions and the Framers' intentions and efforts will have been for nought.

B. The Court Should Reexamine Due Process As It Pertains To Retroactive Legislation.

The American Cause is cognizant of the Court's reluctance, in the aftermath of the *Lochner* [40] case, to sit as a "superlegisla-

[38] Smead, *The Rule Against Retroactive Legislation: A Basic Principle of Jurisprudence*, 20 Minn. L. Rev. 775.

[39] 2 J. Story, *Commentaries on the Constitution of the United States* § 1398 (5th ed. 1891).

[40] *Lochner v. New York*, 198 U.S. 45 (1905).

ture" and substitute its judgements for those of the legislature.[41] As a practical matter, however, the doctrine of substantive due process clearly lives on.[42] The unifying aspect of these cases is a tacit judicial assumption that the Constitution protects civil or non-economic rights and provides a substantially lesser degree of protection to rights regarding property. However, this view is untenable in light of the historical context of the framing of the Constitution.

A cursory examination of the Constitution reveals a deeply rooted concern for property rights.[43] This accurately reflects the importance of all rights to the Framers. The father of the Constitution, James Madison, stated at the Constitutional Convention that, "The primary objects of civil society are in the security of property and the public safety."[44] Later, a prominent Framer, Justice Patterson, wrote in *Van Horne's Lessee v. Dorrance*,[45] "The preservation of property . . . is the primary object of the social compact."[46] In *Boyd v. United States*,[47] this Court wrote: "The great end for which men entered into society was to secure their property. This right is preserved sacred."[48]

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41 See, *e.g.*, *Nebbia v. New York*, 291 U.S. 502 (1934); *West Coast Hotel v. Parrish*, 300 U.S. 379 (1937); *Ferguson v. Skrupa*, 372 U.S. 726 (1963).

42 See, *e.g.*, *Zablocki v. Redhail*, 434 U.S. 374 (1978); *Moore v. E. Cleveland*, 431 U.S. 494 (1977); *Pierce v. Soc'y of Sisters*, 268 U.S. 510 (1925); *Meyer v. Nebraska*, 262 U.S. 390 (1923).

43 See, *e.g.*, U.S. Cons., art. I, § 2, par. 3; art. I, § 9, pars. 3 through 7; art. I, § 10, par. 2; art. IV, § 2, par. 1; art. VI, par. 1; amends. III, IV, V and X.

44 1 M. Farrand, *The Records of the Federal Convention of 1787* 147 (1911).

45 2 U.S. (2 Dall.) 304 (1795).

46 *Id.* at 309.

47 116 U.S. 616 (1885)

48 *Id.* at 627.

The Framers ascribed to the principle that liberty and a well ordered society could only exist where one's rights were protected. That this fundamental principle was embodied in the Constitution and guaranteed the protection of those rights, including property rights, was clearly understood and shared by the federal judiciary well after the Constitutional Convention.[49] It is thus fair to say that economic rights occupied a level of importance in the Framers minds approaching that of, if not equal to, non-economic rights. The modern trend to emphasize the latter and ignore the former is not in accord with the prevailing view at the time of ratification and is thus not in keeping with the original intent of the Framers. In the case at hand, the *fundamental right* of property was impacted by the retroactive application of a statute. This should, in accordance with current cases,[50] trigger heightened scrutiny. Any contrary view, in light of our constitutional history, would by necessity be inconsistent with the intent of the Framers.

The current state of the law in the area of economic legislation, particularly regarding tax legislation, is far from being in accord with the Framers' intent. The doctrines of "general deference" and "tax deference" represent a remarkable indulgence by the judiciary of legislative behavior when it affects economic rights. The present state of constitutional jurisprudence shows much less tolerance of legislative incursions when they affect social or civil rights. Given that the rights of citizens respecting property were of great importance to the Framers, the current judicial bias towards zealously protecting social or civil rights and against affording at least comparable protection to equally or nearly equally important economic rights desiccates the purposes and meaning of a large part of the Constitution.

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49 *Supra*, notes 45 through 48.

50 *Supra*, note 42.

The *amicus*, The American Cause, emphatically does not ask that the Court return to an era of activist jurisprudence abandoned in the aftermath of *Lochner*.[51] Rather, The American Cause asks that the Court revisit the issue of due process and bring its application into balance and accord with the original intent and understanding of the Framers when they drafted the Constitution — an understanding which was and is incompatible with retroactive laws.

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[51] *Supra*, note 40.

CONCLUSION

The decision of the Ninth Circuit should be affirmed.

Respectfully submitted,

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DATED: December 13, 1993

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No. 92-1941

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1993

UNITED STATES OF AMERICA,
Petitioner,
v.
JERRY W. CARLTON,
Respondent.

MOTION OF ANTHONY C. MORICI, JR., AS EXECUTOR OF THE ESTATE OF CAROL M. McNAMEE AND EILEEN McNAMEE AND ANTHONY C. MORICI, JR., AS TRUSTEES OF THE CAROL M. McNAMEE TRUST AGREEMENT TO FILE BRIEF AS AMICI CURIAE IN SUPPORT OF RESPONDENT

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Anthony C. Morici, Jr., as executor of the Estate of Carol M. McNamee, deceased, and Anthony C. Morici, Jr., and Eileen McNamee, as Trustees of the Carol M. McNamee Trust Agreement dated October 12, 1981 (the "McNamee Trust"), hereby move pursuant to Rule 37.4, Rules of the Supreme Court, for leave to file a Brief Amici Curiae in Support of Respondent in the above-entitled matter. The proposed brief is lodged simultaneously herewith. Although petitioner has consented, respondent has refused amici's request for consent to file their proposed brief.

The amici Estate of McNamee and McNamee Trust are currently suing the Internal Revenue Service in the United States Tax Court in San Francisco to contest a notice of estate tax deficiency in the amount of $1,250,490 issued by the IRS in reliance upon the retroactive application of section 10411 of the Omnibus Budget Reconciliation Act of 1987 ("OBRA"), the constitutionality of which is at issue in this case. *Estate of McNamee v. Commissioner,* No. 8789-91 (T.C., filed May 9, 1991). The principal issue in *Estate of McNamee* is identical to the issue here: whether section 10411 of the Omnibus Budget Reconciliation Act of 1987 can constitutionally be applied to deny the estate tax deduction offered under IRC section 2057 as enacted in the Tax Reform Act of 1986, Publ. L. No. 99-514, section 1172, 100 Stat. 2085, in connection with the sale of stock to an Employee Stock Ownership Plan (ESOP) completed before the amending statute was introduced.

The one important difference between *Carlton* and amici's case — and the one that impels them to offer this brief — is that amici, unlike respondent, engaged in the purchase of stock and its subsequent sale to an ESOP *after* the issuance of IRS Notice 87-13 on January 5, 1987 but *before* the introduction in Congress of amending legislation on February 26, 1987. Unlike respondent, therefore, amici have reason to argue that the constitutionally allowable date of retroactivity is no earlier than the date of introduction of the legislation, not the date of the IRS's press release announcing its interpretation of the 1986 statute. At respondent's invitation the Ninth Circuit limited the principle under which respondent prevailed by stating, in *obiter dictum,* that retroactive application of the statute would have been proper

from and after January 5, 1987, the date upon which IRS Notice 87-13 was issued. That *obiter dictum* follows:

> We do not doubt the power of Congress to apply legislation retroactively to the time such legislation was introduced, or even to the time such legislation was proposed by the executive branch. *See Purvis [v. United States]*, 501 F.2d at 313-14 (retroactive application of "interest equalization tax" on American purchases of foreign securities to the time when first proposed by the President does not violate due process). During this time period, the taxpayer is on notice that a change in law is forthcoming. The government has a strong interest in capturing within its taxing powers transactions deliberately rushed through in anticipation of a pending change of law. Our conclusion would likely be entirely different if Carlton had engaged in his transaction after January 5, 1987. *See Ferman v. United States*, 790 F. Supp. 656 (E.D. La. 1992) (rejecting claim that decedent ownership requirement was unconstitutionally applied to transaction in February 1987).
>
> *Carlton v. United States*, 972 F.2d 1051, 1062 (9th Cir. 1992).

That conclusion is potentially fatal to the claim of amici's estate if followed, and it is wrong for the two reasons argued in amici's proposed brief but not by respondent: Notice 87-13 failed by its own terms to give adequate notice of the subsequent retroactive amendment, and in any event a low-level executive pronouncement is ineffective to notify taxpayers of prospective legislative amendments to tax statutes.

Neither of these arguments is made by respondent, who repeats in this Court his invitation that retroactivity be limited to transactions occurring after Notice 87-13.[1] The purpose of amici's proposed brief is to persuade the Court to decline that invitation and to rule instead that the statute cannot be retroactively applied

[1] *See* Appellant's Brief at 39 (Ninth Circuit); Appellant's Reply Brief at 11 (Ninth Circuit); Respondent's Brief in Opposition to Petition for Certiorari at 7 n.5.

to transactions occurring prior to its introduction in Congress. For that reason the arguments offered in the proposed brief of amici are new and not made by the parties.

Amici are therefore vitally interested in the outcome of this case because, depending upon the reach of this Court's decision, it will certainly influence and may govern the outcome of amici's own litigation and will do so before amici's suit can be pursued to judgment.

Because of the difference between respondent's and amici's cases amici are confident that the questions of law they address are not, and will not be, addressed by the parties.

Amici therefore respectfully move that this Court accept and file the proposed brief amici curiae, lodged contemporaneously with this motion.

Dated: December 10, 1993

Respectfully submitted,

By /s/ DAVID W. HETTIG

By /s/ CHARLES C. MARSON

Attorneys for Amici

Supreme Court of the United States

October Term, 196[illegible]

UNITED STATES OF AMERICA,

Petitioner,

v.

JERRY W. CARLTON,

Respondent.

On Writ of Certiorari to the

United States Court of Appeals for the [illegible] Circuit

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1993

No. 92-1941

UNITED STATES OF AMERICA,

Petitioner,

v.

JERRY W. CARLTON,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MOTION FOR LEAVE TO FILE BRIEF *AMICI CURIAE* IN SUPPORT OF RESPONDENT

Pursuant to Rule 37.4 of the rules of this Court, the Washington Legal Foundation; United States Senators Pete Domenici, Larry E. Craig, John McCain, Slade Gorton, Bob Smith, Trent Lott, Conrad Burns, Kay Bailey Hutchison, Connie Mack, Dan Coats, Jesse Helms, Robert F. Bennett, William V. Roth, Jr., Malcolm Wallop, Dirk Kempthorne, Strom Thurmond, Paul D. Coverdell, Christopher S. Bond, Orrin Hatch, Alfonse M. D'Amato, Ted Stevens, Don Nickles; U.S. Representatives Newt Gingrich, Chris Cox, Gerald Solomon, Dana Rohrabacher, Robert K. Dornan, Deborah Pryce, Jack Kingston, Bill Baker, Peter T. King, John Boehner, Steve Buyer, Jim Bunning, Bob Walker, Joe Knollenberg, Cass Ballenger, Mel Hancock, Rod Grams, Tom Ewing, Tom Bliley, Elton Gallegly; Governor Kirk Fordice of Mississippi; and the Allied Educational Foundation, respectfully move this Court for leave to file the attached brief *amici curiae* in support of the respondent. The petitioner has provided

written consent to the filing of this brief; however, the respondent has refused to provide such consent.

INTERESTS OF *AMICI CURIAE*

The Washington Legal Foundation (WLF) is a non-profit public interest law and policy center with over 100,000 members and supporters nationwide who are taxpayers. WLF advocates principles of limited government under the Constitution and promotes the free enterprise system before the courts, regulatory agencies, and the public. WLF has appeared before this Court on numerous occasions as *amicus curiae* over the last 15 years. *See, e.g., TXO Production Corp. v. Alliance Resources Corp.*, 113 S. Ct. 2711 (1992); *General Motors Corp. v. Romein*, 112 S. Ct. 1105 (1992). WLF's Legal Studies Division also publishes articles, monographs, and studies on constitutional and regulatory issues.

United States Senators Pete Domenici, *et al.*, and United States Representatives Newt Gingrich, *et al.*, are all duly elected Members of Congress who have a keen interest in the instant case. As Members of Congress, these legislators are responsible for voting on and enacting tax and other legislation affecting the Nation and its citizenry. From time to time, they have been called upon to vote on tax legislation that has retroactive application, and believe that such laws are fundamentally unfair and should be constitutionally sanctioned in only rare cases pursuant to a clear rule of law.

In this regard, many Congressional *amici* have proposed, debated, and/or voted on legislation or other procedures that would limit the passage of retroactive tax laws. *See, e.g.*, 139 Cong. Rec. S14243-59 (daily ed. Oct. 25, 1993); *id.* S14319 (daily ed. Oct. 26, 1993); *id.* S14493-97 (daily ed. Oct. 27, 1993); *id.* S14568-74 (daily ed. Oct. 28, 1993).

Governor Kirk Fordice is the duly elected governor of Mississippi. As governor of a State, he has the

responsibility for determing that State's budget which depends in large measure on federal tax laws and revenues raised at the federal level. Like his Congressional co-*amici*, Governor Fordice also strongly opposes retroactive tax meaures as being fundamentally unfair to the citizens of his state.

The Allied Educational Foundation (AEF) is a non-profit, charitable and educational foundation based in Englewood, New Jersey. Founded in 1964, AEF is dedicated to promoting education in law and public policy, and has appeared with WLF as *amicus curiae* in numerous cases before this and other courts.

All *amici* believe that their participation in this case will assist the Court in resolving the constitutional question before it. *Amici* bring a broader perspective to this case than do the parties, and present this Court with historical and legal arguments that are either not addressed or not fully discussed by the parties.

Accordingly, movants respectfully request that they be allowed to participate in this case and file the annexed brief *amici curiae* in support of the respondent.

Respectfully submitted,

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IN THE
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OCTOBER TERM, 1993

No. 92-1941

UNITED STATES OF AMERICA,

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v.

JERRY W. CARLTON,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR *AMICI CURIAE* IN SUPPORT OF RESPONDENT

INTERESTS OF *AMICI CURIAE*

The interests of *amici curiae* Washington Legal Foundation, *et al.*, are set forth in the accompanying motion for leave to file this brief.

STATEMENT OF THE CASE

In the interest of judicial economy, *amici* adopt the statement of the case in respondent's brief. The following summarized facts are pertinent to *amici*'s argument.

In September 1986, the 99th Congress enacted, as part of the "Tax Reform Act of 1986," Pub. L. No. 99-514, 100 Stat. 2085, a provision codified as 26 U.S.C. § 2057 (repealed 1989), which allowed an estate to deduct from the value of the decedent's gross estate half of the

"qualified proceeds" of a "qualified sale" of certain securities to an Employee Stock Ownership Plan ("ESOP"). The 99th Congress adjourned on October 18, 1986, and four days later, on October 22, 1986, the Tax Reform Act of 1986, including section 2057, became law.

In December 1986, in specific reliance on the new "ESOP proceeds deduction" provision contained in section 2057, Jerry W. Carlton, Executor for the Will of Willametta K. Day, purchased 1,500,000 shares of MCI stock for a total of $11,206,000. He promptly sold the shares to the MCI ESOP for $10,575,000. It has been conceded below that but for the section 2057 deduction, Carlton would not have sold the shares at $631,000 below his purchase price.

Later that month, the sale to the MCI ESOP having been irrevocably completed, Carlton filed the estate tax return, deducting $5,287,500 from the gross estate pursuant to the ESOP proceeds deduction contained in section 2057.

In January 1987, the Internal Revenue Service ("IRS") issued an advance version of a notice that it would not recognize an ESOP proceeds deduction under the Tax Reform Act of 1986 under circumstances applicable to Carlton's transaction. In February 1987, a bill was introduced in the newly elected and substantially transformed 100th Congress (the majority in the Senate had shifted from the Republicans to the Democrats) to codify the IRS's restrictions. Finally, in December 1987, an amendment labeled "Congressional Clarification of Estate Tax Deduction for Sales of Employer Securities," was enacted as part of the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330, which purported to conform the Tax Reform Act of 1986 to "the original intent of Congress." H.R.Rep. No. 100-391, 100th Cong., 1st Sess., Pt. II, at 1045, *reprinted in* 4 U.S.C.C.A.N. 2313-1, 2313-661 (1987).

After an IRS audit, Carlton paid an estate tax deficiency resulting from, *inter alia*, the retroactive application of the 1987 amendment. Carlton filed a refund claim for that part of the deficiency attributable to the ESOP proceeds deduction. The IRS denied the claim. Carlton then filed an action in federal district court seeking a refund of the taxes attributable to the section 2057 deduction, plus interest, costs and attorneys' fees. The parties below agreed that, if the 1987 amendment could not be retroactively applied consistently with due process, the estate was entitled to the section 2057 deduction as passed in 1986; conversely, if the amendment could be retroactively applied, Carlton could not claim the ESOP proceeds deduction.

Upon cross motions for summary judgment, the district court ruled against Carlton. The Ninth Circuit reversed and remanded on the grounds that "the 1987 amendment . . . , as applied to the transaction at issue here, violated the Due Process Clause of the Fifth Amendment." *Carlton v. United States*, 972 F.2d 1051, 1062 (9th Cir. 1992).

SUMMARY OF ARGUMENT

This case is not about tax evasion; it is about a taxpayer's response to a tax incentive written into law by one Congress, the wisdom of which was reconsidered by a later and substantially recomposed Congress. *Amici* submit that the reconsidered policy may be legitimately applied only to transactions that had not yet been completed. Retroactive legislative changes purporting to affect transactions that have irrevocably closed, as in this case, are pernicious to the concept of ordered liberty. Accordingly, *amici* urge the Court to affirm the Ninth Circuit's holding, and in so doing to clarify the rule of law underlying the current "so harsh and oppressive" due process test for retroactive taxation. It is the experience of *amici*, who include 42 Members of Congress, that the test as currently phrased provides little guidance as to the

outer bounds of Congress' constitutional power to impose retroactive taxes.

To assert that retroactivity is disfavored in the American legal tradition is a gross understatement. Two centuries ago, retroactive laws were considered by most relevant authorities (each discussed *infra*) to be "contrary to the first principles of the social compact," "against natural right," "equally unjust in civil as in criminal cases," "the instrument of some of the grossest acts of tyranny that were ever exercised," "highly injurious," "oppressive," "pernicious," "the height of injustice," "repugnant to common justice," and/or "wrong."

Retroactive taxation is fundamentally antithetical to the "rule of law," which in a free society permits individuals to plan and conform their lives in accordance with ascertainable rules. Retroactive tax law -- by definition not ascertainable in advance -- thus go to the heart of ordered liberty, a fundamental, procedural, civil right of citizens which may be overridden only by the most compelling of legislative purposes.

Amici urge the Court to look closely not only at the due process clauses, but also at the federal *ex post facto* clause, as well as other constitutional and historical indicia, for insight into the meaning of the due process clause upon which the Ninth Circuit's decision rests. *Amici* believe the constitutional text and all available indicia demonstrate that the framers and ratifiers of the Constitution intended to prohibit the type of retroactive tax law at issue in this case.

Accordingly, *amici* urge the Court to adopt the following bright-line constitutional test for retroactive federal taxation: retroactive application of a federal tax law is *per se* unconstitutional as to completed transactions and otherwise presumptively unconstitutional unless necessary to achieve a compelling legislative purpose independent of the desire to raise additional revenues.

ARGUMENT

I. RETROACTIVE TAXES ARE ANTITHETICAL TO THE RULE OF LAW

The Solicitor General argues that the three-part due process formula utilized by the Ninth Circuit,[1] which barred retroactive application of the amended federal tax law because it was "so harsh and oppressive," lacks a foundation in the Constitution. United States Brief at 10, 19-29. But the Solicitor General suggests no meaningful alternative. Essentially, the Solicitor General proposes that the Court eliminate all substance from the current constitutional tests for retroactive federal taxes.

Amici emphatically object to this proposal, which, as explained below, is antithetical to the rule of law and demonstrably repugnant to the intent of the framers and ratifiers of the United States Constitution. *Cf.* W. Blackstone, 1 *Commentaries on the Laws of England* 46 (1765) (retroactive laws are procedurally "more unreasonable" than those of "Caligula, who (according to Dio Cassius) wrote his laws in a very small character, and hung them up upon high pillars, the more effectively to ensnare the people").

A. The Current Retroactivity Test for Federal Taxation is Not a Clear Rule of Law

The foremost problem with retroactive legislation is that it is inimical to the Rule of Law. In *Marbury v. Madison*, Chief Justice John Marshall stressed that "[t]he government of the United States has been emphatically termed a government of laws, and not of men." 5 U.S. (1

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[1] The Ninth Circuit's test looks to: (i) whether the taxpayer had "actual or constructive notice that the tax statute would be retroactively amended," (ii) whether the taxpayer relied "to his detriment on the pre-amendment tax statute," and (iii) whether "such reliance [was] reasonable." *Carlton v. United States*, 972 F.2d at 1059.

Cranch) 137, 163 (1803).[2] Chief Justice Marshall later admonished that "the power to tax involves the power to destroy." *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 431 (1819).

When addressing challenges to retroactive civil legislation, modern courts typically resort to a "minimum scrutiny" due process balancing test: "Provided that the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches . . . ." *Pension Benefit Guarantee Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 729 (1984). In the tax context, this Court has stated that "we must 'consider the nature of the tax and the circumstances in which it is laid before it can be said that its retroactive application is so harsh and oppressive as to transgress the constitutional limitation.'" *United States v. Hemme*, 476 U.S. 558, 568-69 (1986) (quoting *Welch v. Henry*, 305 U.S. 134, 147 (1938)). It is the experience of *amici* that this test provides little guidance as to the outer bounds of Congress' constitutional power to impose retroactive taxes. *See generally* Note, *Has Due Process Struck Out? The Judicial Rubberstamping of Retroactive Economic Laws*, 42 *Duke L.J.* 1069 (March 1993).

If the Solicitor General's position is accepted, this Court's retroactivity caselaw will have evolved into a blatant "rule of men," dependent upon which judge analyzes the case -- as one ancient authority described it,

[2] *See* S. von Pufendorf, VII *De Jure Naturae et Gentium: Libri Octo* Ch. VI, § 11 (1688) (C.H. & W.A. Oldfather trans. 1934) ("[I]t is clear in what sense is to be taken the statement of the ancient Greek writers on politics and their followers, namely, that the government of a state should be committed to laws rather than to men. For that can have no other fit meaning than this: Care should be taken that those who rule should govern the commonwealth according to the direction of established laws, rather than by their own private and uncircumscribed pleasure." (Citation omitted)).

the legal equivalent of "a mariner's compass without a skipper to direct a ship." Pufendorf, *supra*, Ch. VI, § 11. The dissenting opinion below, applying the same caselaw to the same facts, proves the propensity of the current due process test to breed subjective judgments. *Compare* 972 F.2d at 1061 ("the estate's reliance on the plain language of [the ESOP proceeds deduction] was reasonable") *with* 972 F.2d at 1065 (Norris, J., dissenting) ("I [would not] find his reliance on the statute as originally passed to have been reasonable"). *Amici* implore this Court to clarify the constitutional rule of law for retroactive federal tax legislation, thereby providing both a pilot and stars by which to steer this vessel in the armada of constitutional due process caselaw.

B. The Solicitor General's Reasoning Begs the Question of Retroactivity

All legislation affecting individual rights must be "justified by a rational legislative purpose." *Pension Benefit Guarantee Corp. v. R.A. Gray & Co.*, 467 U.S. at 730. But the "rational legislative purpose" that justifies the prospective application of a law cannot *per se* justify retroactive application of the law. *Id.* ("retroactive legislation does have to meet a burden not faced by legislation that has only future effects"). *A fortiori*, retroactivity cannot be sustained by a legislative purpose that merely describes the retroactivity, *i.e.* that the retroactive law is "designed 'to bring the revenue loss in line with the original estimate and Congressional intent.'" United States Brief at 6, *citing* H.R. Rep. No. 391, 100th Cong., 1st Sess., Pt. II, at 1045.

The Solicitor General confuses "interest," "objective," and "purpose" in the following illogical sequence:

- "Congress unquestionably has a legitimate *interest* in designing revenue laws to fairly allocate to taxpayers the burdens and benefits of national fiscal policies and to prevent evasion of those laws 'by the vigilant and ingenious.'" United States Brief at 15

(quoting Justice Brandeis' dissent in *Untermyer v. Anderson*, 276 U.S. 440, 450-51 (1928)) (emphasis added);

• "If an unintended loophole is written into an enacted statute, and if Congress acts promptly to correct that error through curative legislation, it cannot be said that retroactive correction of the error lacks a rational relationship to the government's legitimate legislative *objective*." United States Brief at 15 (emphasis added);

• "A curative, retroactive statute rationally designed to accomplish that legitimate *purpose* satisfies the requirements of due process." United States Brief at 15 (emphasis added).

This reasoning has at least three fatal flaws. First, it is premised on the mistaken idea that "tax avoidance" is the same as "tax evasion." Taxpayers in the United States have a legal right to avoid taxes "by means which the law permits." As Judge Learned Hand explained in *Helvering v. Gregory*: "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465, 469 (1935) (Sutherland, J.) ("The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.") (internal citations omitted). That Congress may have a legitimate interest in preventing tax evasion is wholly irrelevant to this case, which involved legislatively-induced tax avoidance.

Second, and more fundamentally, the Solicitor General's reasoning begs the question of retroactivity in disregard of this Court's admonition that "the retroactive application of the legislation [must] itself [be] justified by

a rational legislative purpose." 467 U.S. at 730.[3] The Solicitor General neither attempts to justify the retroactive application by necessity -- a central component of the Court's reasoning in *Pension Benefit Guarantee Corp.*[4] -- nor disputes that whatever legislative purposes underlie the 1987 amendment could have been achieved through purely prospective legislation.

In effect, the Solicitor General argues that individuals who engage in lawful tax avoidance can later be taxed retroactively for no other reason than to raise more revenues. On this rationale, Congress could, for instance, pass a law to tax inheritances retroactive to 1789, and

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[3] This sequence can also be refuted as a logical fallacy known as the "fallacy of the undistributed middle," whereby the term "legislation" is the undistributed predicate of the following two premises: (A) all constitutional federal tax laws are legislation; and (B) all curative enactments are legislation. From these two premises, the Solicitor General argues that because (C) this law is a curative enactment, therefore (D) this law is a constitutional federal tax law. But the sorites (series of incomplete syllogisms) breaks down because the middle term of the first series (legislation) is undistributed (some legislation is curative and some legislation is constitutional, but not all curative legislation is constitutional -- this is the critical point the Solicitor General's argument misses).

[4] *See Pension Benefit Guarantee Corp.*, 467 U.S. at 730-31 ("One of the primary problems Congress identified under ERISA was that the statute encouraged employer withdrawals from multiemployer plans. And Congress was properly concerned that employers would have an even greater incentive to withdraw if they knew that legislation to impose more burdensome liability on withdrawing employers was being considered. . . . Withdrawals occurring during the legislative process not only would have required that remaining employers increase their contributions to existing pension plans, but also could have ultimately affected the stability of the plans themselves. Congress therefore utilized retroactive application of the statute to prevent employers from taking advantage of a lengthy legislative process and withdrawing while Congress debated necessary revisions in the statute. Indeed, as the amendments progressed through the legislative process, Congress advanced the effective date chosen so that it would encompass only that retroactive time period that Congress believed would be *necessary to accomplish its purposes*." (Emphasis added)).

"justify the retroactive tax on the need to pay the federal debt or to balance the federal budget.

Necessity, however, was the only excuse countenanced at the time of the drafting and ratification of the Constitution for an exception to the general rule against *ex post facto* laws. And legal necessity can never be equated with political expedience. During the constitutional debate, James (later Justice) Iredell made the following observations about *ex post facto* laws being tolerable only in cases of "invincible necessity":

> *Ex post facto* laws may sometimes be convenient, but that they are ever absolutely necessary I shall take the liberty to doubt, till that necessity can be made apparent. Sure I am, they have been the instrument of some of the grossest acts of tyranny that were ever exercised, and have this never failing consequence, to put the minority in the power of a passionate and unprincipled majority, as to the most sacred things, and the plea of necessity is never wanting where it can be of any avail.

Iredell, *Observations on George Mason's Objections to the Federal Constitution*, in *Pamphlets on the Constitution of the United States: Published During Its Discussion by the People 1787-1788* 333, 368 (P. Ford ed. 1888). The Solicitor General has not pled necessity because there was no "invincible necessity" for the retroactive application of the 1987 "Congressional Clarification of Estate Tax Deduction for Sales of Employer Securities."

Finally, the Solicitor General's reasoning casually disregards statutory text in favor of contradictory "legislative intent,"[5] in an effort to forge a justifying

[5] This case is not like *Helvering v. Gregory*, *supra*, where the Court was interpreting arguably consistent text and legislative intent. 293 U.S. at 469 (focussing on "whether what was done, apart from the tax motive, was the thing which the *statute* intended" (emphasis

legislative purpose *for retroactive legislation* that bears little or no relation to an enumerated grant of power in the Constitution, presumably in this case to the power enumerated in Article I, Section 8, "[t]o lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States." U.S. Const. art. I, § 8, cl. 1; *see United States v. Butler*, 297 U.S. 1, 64 (1936).

Were the Court to adopt the Solicitor General's logic, Congress could with impunity pass laws that, for instance, permit tax deductions for political contributions, but then retroactively change the law when Members of Congress realize, *post hoc*, that: (1) the contributions overwhelmingly favored anti-incumbency; (2) the revenues lost vastly exceeded expectations; or (3) both. This hypothetical is not far off from what transpired in this case. The fundamental question in the hypothetical, as well as in this case, is this: Where in the Constitution did the States respectively or the people cede such power to Congress? *See Butler*, 297 U.S. at 63 ("The question is not what power the federal government ought to have, but what powers in fact have been given by the people."), *quoted in New York v. United States*, ___ U.S. ___, ___, 112 S. Ct. 2408, 2418 (1992).

The Solicitor General ignores this fundamental question. Instead, he asks this Court to confer upon Congress, in effect, "[a]n unlimited power to make any and everything lawful which the legislature might see fit to call taxation, . . . plainly stated, an unlimited power to

added)). When, as in this case, alleged "legislative intent" conflicts with the actual words enacted into law, the text controls. *See St. Martin Evangelical Church v. South Dakota*, 451 U.S. 772, 790 (1981) (Stevens, J., concurring) (although legislative history may offer evidence of contrary intent, the statutory text may "simply fail[] to give effect to that intention."); *cf. United States v. Heth*, 3 Cranch 399, 409 (1806) (Johnson, J.) (ambiguous statutory "words should be taken most strongly '*contra proferentum*'"); 3 Cranch at 413 (Paterson, J.) ("[T]he words of a statute, if dubious, ought . . . to be taken most strongly against the law makers.").

plunder the citizen." T. Cooley, "The Power of Taxation," *Constitutional Limitations* 488 (1868). *Amici* believe the American people deserve better -- and are entitled to better under *their* Constitution.

II. THE COURT SHOULD PROVIDE A "BRIGHT LINE" CONSTITUTIONAL TEST FOR RETROACTIVE FEDERAL TAXATION: RETROACTIVE APPLICATION OF A FEDERAL TAX LAW IS *PER SE* UNCONSTITUTIONAL AS TO COMPLETED TRANSACTIONS AND OTHERWISE PRESUMPTIVELY UNCONSTITUTIONAL UNLESS NECESSARY TO ACHIEVE A COMPELLING LEGISLATIVE PURPOSE

Although the Ninth Circuit based its retroactivity decision on the due process clause of the Fifth Amendment, that holding necessarily implicates other textual and structural provisions of the Constitution dealing with retroactivity, foremost of which are the two *ex post facto* clauses.[6] *Amici* urge the Court to look closely at the federal *ex post facto* clause, as well as other constitutional indicia, not only for their own respective merits, but for insight into the meaning of the due process clause upon which the Ninth Circuit's decision rests. *See generally* Amar, *The Bill of Rights as a Constitution*, 100 Yale L.J. 1131, 1201 (1991) ("How could we forget that our Constitution is a *single* document, and not a jumble of disconnected clauses -- that it is *a* Constitution we are expounding." (Emphasis in original)).

[6] U.S. Const. art. I, § 9 (Congress) & art. I, § 10 (states).

A. Unlike the State Legislative Power at Issue in *Calder v. Bull*, Congress' Powers Are Limited to Those Enumerated in the U.S. Constitution

It is still axiomatic in the late Twentieth Century that "[t]he Constitution created a Federal Government of limited powers." *New York v. United States*, ___ U.S. at ___, 112 S. Ct. at 2417 (citation omitted). Nevertheless, whether and to what extent Congress has the power to enact retroactive civil laws today does not lend itself to clean constitutional analysis, due to the seminal retroactivity case of *Calder v. Bull*, 3 U.S. (3 Dall.) 386 (1798).

In *Calder v. Bull*, the Court is generally understood to have held that the Constitution's two express prohibitions against *ex post facto* laws only apply to criminal legislation. A close reading of Justice Iredell's and Justice Peterson's separate concurring opinions in *Calder v. Bull*, however, suggests that the holding of the Court would have been different had the legislative power at issue been federal instead of state, as explained more fully below. This case presents a clean opportunity for the Court to revisit or distinguish *Calder v. Bull*, and to clarify the constitutional limits on Congress to enact tax legislation retroactively.

Calder v. Bull involved state legislation that "set aside a decree of the court of Probate for Hartford . . . and granted a new hearing." 3 U.S. (3 Dall.) at 386 (Chase, J.). As was the custom at the time, the Supreme Court delivered the opinions of the various justices *seriatim*. Justice Chase opined that the *ex post facto* prohibition applicable to the Connecticut legislature applied only to four types of criminal laws. 3 U.S. (3 Dall.) at 390. Justices Paterson and Iredell, in separate concurring opinions, expounded on the "indefinite nature" of the Connecticut Legislature's powers, which at the time included both legislative *and judicial* functions (in stark contrast to the federal Legislature's powers then and now).

The Court's decision in *Calder v. Bull* is thus not controlling precedent in a case involving the federal legislature, which unlike the legislative power at issue in *Calder v. Bull*, is constrained not only by explicit due process and *ex post facto* restrictions, but also by other organic, structural, and textual constitutional constraints on the exercise of federal legislative power. Accordingly, this case should be treated as both a due process case and a case of first impression under the federal *ex post facto* clause, as construed together with the other indicia of the intent of the framers and ratifiers of the United States Constitution vis-à-vis retroactive federal taxation.

B. The Constitution Restricts the Power of the Federal Government to Enact Retroactive Legislation of the Type in this Case

1. *Textual indicia*

a. Due process clauses

The Fifth Amendment provides that "[n]o person shall be . . . deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation." U.S. Const. amend. V; *cf.* U.S. Const. amend XIV ("No state shall . . . deprive any person of life, liberty, or property, without due process of law."). The Solicitor General concedes that the "guaranty of due process" protects individuals from "unreasonable, arbitrary or capricious" governmental regulation of commercial matters. United States Brief at 12, *quoting Nebbia v. New York*, 291 U.S. 502, 525 (1934). *Amici* believe that retroactive taxation is antithetical to the rule of law and therefore *per se* "unreasonable, arbitrary or capricious" as a matter of procedural due process. As Justice Powell emphasized in *Mathews v. Eldridge*, 424 U.S. 319 (1976), "[t]he essence of due process is the requirement that 'a person in jeopardy of serious loss [be given] notice of the case against him and opportunity to meet it.'" 424 U.S. at 348 (quoting *Joint Anti-Fascist Comm. v. McGrath*, 341 U.S.

123, 171-72 (1951) (Frankfurter, J., concurring)). Retroactive legislation provides neither notice nor an opportunity "to meet it."

Amici dispute the Solicitor General's characterization of the Ninth Circuit's holding as concocting a new economic strain of *substantive* due process.[7] The Ninth Circuit's opinion focused on *procedural* not substantive issues, foremost of which is notice. *Carlton*, 972 F.2d at 1059 (first of two "paramount" circumstances is whether the taxpayer had "actual or constructive notice that the tax statute would be retroactively amended"); *see United States v. Hemme*, 476 U.S. at 569 ("One of the relevant circumstances is whether, without notice, a statute gives a different and more oppressive legal effect to conduct undertaken before enactment of the statute."); *see generally McNabb v. United States*, 318 U.S. 332, 347 ("The history of liberty has largely been the history of observance of procedural safeguards."), *reh'g denied*, 319 U.S. 784 (1943).

The procedural nature of constraints on retroactive lawmaking, whether criminal or civil, is made clear by Blackstone's famous exposition on "The Nature of Laws in General," wherein he discusses the several properties of "municipal or civil law," as distinguished from "the law of nature, the revealed law, and the law of nations":

> [Municipal or civil law] is likewise "a rule *prescribed*." Because a bare resolution, confined in the breast of the legislator, without manifesting itself by some external sign, can never be properly a law. It is requisite that this resolution

[7] The Solicitor General begins both the "Reasons for Granting Petition" section of the United States' Petition for Certiorari and the "Argument" section of the merits brief with the following sentence: "The decision of the court of appeals adopts and applies a novel and erroneous three-step substantive due process test for determining the constitutionality of retroactive tax legislation." United States Cert. Petition at 10; United States Brief at 12.

> be notified to the people who are to obey it. But the manner in which this notification is to be made, is matter of very great indifference. . . . Yet, whatever way is made use of, it is incumbent on the promulgators to do it in the most public and perspicuous manner; not like Caligula, who (according to Dio Cassius) wrote his laws in a very small character, and hung them up upon high pillars, the more effectively to ensnare the people. There is still a more unreasonable method than this, which is called making of laws *ex post facto*; when *after* an action is committed, the legislator then for the first time declares it to have been a crime, and inflicts a punishment upon the person who has committed it; here it is impossible that the party could foresee that an action, innocent when it was done, should be afterwards converted to guilt by a subsequent law; he had therefore no cause to abstain from it; and all punishment for not abstaining must of consequence be cruel and unjust. All laws should be therefore made to commence *in futuro*, and be notified before their commencement; which is implied in the term "*prescribed*."

W. Blackstone, 1 *Commentaries on the Laws of England* 45-46 (1765) (emphasis in original).[8]

Because this case presents a *procedural* conflict between individual rights and expectations on the one hand

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[8] *See Dash v. Van Kleeck*, 7 Johns. 477, 495 (N.Y. Sup. Ct. 1811) (Thompson, J.) ("After referring to the unjust and iniquitous practice of the *Roman* emperor, (*Caligula*), as to the manner of writing and publishing his laws, [Blackstone] observes, that there is still a *more unreasonable* method than this, which is called making laws *ex post facto*. Although, technically speaking, the term *ex post facto* may be applicable only to laws punishing criminal offenses, the principle is equally applicable to civil cases." (Emphasis in original)); *see generally Reno v. Flores*, ___ U.S. ___, ___, 113 S. Ct. 1439, 1455 (1993) (O'Connor, J., concurring) ("procedural due process protections" include "notice of charges").

and the federal government's desire to raise more revenues on the other, it fits squarely within the "principal function of the Due Process Clause." *McGautha v. California*, 402 U.S. 183, 254 (1971) (Brennan, J., dissenting, joined by Douglas and Marshall, JJ.) ("The principal function of the Due Process Clause is to ensure that state power is exercised only pursuant to procedures adequate to vindicate individual rights."), *vacated sub nom. Crampton v. Ohio*, 408 U.S. 941 (1972). If ever there was a fundamental civil right, albeit procedural, that is both "deeply rooted in this Nation's history and tradition," *Moore v. East Cleveland*, 431 U.S. 494, 503 (1977) (Powell, J.), and "implicit in the concept of ordered liberty," *Palko v. Connecticut*, 302 U.S. 319, 325, 326 (1937), it is the right to be free from retroactive governmental deprivations of personal property, such as the retroactive taxation imposed upon Carlton first by the IRS and then sanctioned by the Congress.

In explaining its due process holding, the Ninth Circuit emphasized that "[f]ederal courts have long been hostile to legislation that interferes with settled expectations." 972 F.2d at 1057 (citation omitted). This historic hostility towards "legislation that interferes with settled expectations" -- a common thread between due process and *ex post facto* restrictions on governmental power -- is not restricted to federal courts, but is prevalent as well among the historic writings that most influenced the framers and ratifiers of the United States Constitution.

As retroactivity in tax legislation eviscerates all other procedural protections, *amici* urge the Court to adopt a bright-line test that will prevent retroactive application of any federal tax law to completed transactions and will otherwise safeguard individual rights by creating a presumption of unconstitutionality unless the retroactive application of a new tax law is necessary for the achievement of a compelling legislative purpose independent of the desire to raise additional revenues.

b. *Ex post facto* clauses

Article I, section 9 of the U.S. Constitution, concerning restraints on Congress, states that "[n]o Bill of Attainder or *ex post facto* Law shall be passed." In a similar manner, article I, section 10 states that "[n]o State shall . . . pass any Bill of Attainder, *ex post facto* Law, or Law impairing the Obligation of Contracts." Practically all of this Court's caselaw examining and construing the term "*ex post facto*" involves the latter, and not the former. *See Collins v. Youngblood*, ___ U.S. ___, ___, 110 S. Ct. 2715, 2718-20 (1990) (Rehnquist, C.J., reviewing the litany of cases since *Calder v. Bull* that have restricted the term "to penal statutes which disadvantage the offender affected by them"). The Court's few cases involving the federal *ex post facto* prohibition typically cite *Calder v. Bull* (construing the state *ex post facto* prohibition) or other authorities stemming therefrom.[9]

The Court apparently has never before been faced with a federal *ex post facto* case that hearkened back to the distinguishing factors expounded by Justices Iredell and Paterson in *Calder v. Bull*, mentioned *supra* and discussed more fully *infra*. The Court's caselaw, however, has never fully closed the door on the obvious distinctions between federal and state *ex post facto* restrictions. For instance, Chief Justice Rehnquist's opinion in *Collins* suggests, at least implicitly, that the restrictive interpretation stemming from *Calder v. Bull* is limited to the state *ex post facto* clause. *See* ___ U.S. at ___, 110 S. Ct. at 2719 n.2 ("the Court has consistently adhered to the view expressed by Justices Chase, Paterson, and Iredell in *Calder* that the *Ex Post Facto* Clause applies only to penal statutes.").

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[9] *See, e.g.*, *Kaiser Aluminum & Chemical Co. v. Bonjorno*, 494 U.S. 827, 855-56 (1990) (Scalia, J., concurring); *Harisiades v. Shaughnessy*, 342 U.S. 580, 594-95 (Jackson, J.), *reh'g denied*, 343 U.S. 936 (1952); *Mahler v. Eby*, 264 U.S. 32, 39 (1924) (Taft, C.J.); *Johannessen v. United States*, 225 U.S. 227, 242 (1912) (Pitney, J.).

In any case, while the contexts of the respective *ex post facto* prohibitions are quite distinguishable (see discussion of structural indicia, *infra*), they both evince a firm belief that retroactivity -- which results in the unsettling of established rights and/or expectations -- is inherently pernicious. Confirming this belief, James Madison wrote that "*ex-post-facto* laws, and laws impairing the obligation of contracts are contrary to the first principles of the social compact, and to every principle of sound legislation." *The Federalist* No. 44, at 128 (R. Fairfield 2d ed. 1966). The Congressional Research Service recognizes the historical legitimacy of arguments that the *ex post facto* clauses should apply to all legislation: "At the time the Constitution was adopted, many persons understood the terms *ex post facto* laws to 'embrace all retrospective laws, or laws governing or controlling past transactions, whether . . . of a civil or a criminal nature.'" Congressional Research Service, *The Constitution of the United States: Analysis and Interpretation*, S. Doc. No. 16, 99th Cong., 1st. Sess. 381-82 (1987) (quoting 3 J. Story, *Commentaries on the Constitution of the United States* § 1339 (Boston: 1833)).

Supporting the then-popular sentiment that retroactive criminal and civil laws were seen in the same light, the New Hampshire Constitution of 1784 warns that "[r]etroactive laws are highly injurious, oppressive, and unjust. No such law, therefore, should be made, either for the decision of civil causes, or the punishment of offenses." N.H. Const. of 1784, Part 1, § 23.

It is clear from the writings of Thomas Jefferson that the framers' abhorrence of *ex post facto* laws applied to all federal laws, whether civil or criminal. In 1813, for example (even after *Calder v. Bull*), Jefferson wrote of the retroactive application of a congressional patent law:

> Every man should be protected in his lawful acts, and be certain that no *ex post facto* law shall punish or endamage him for them. . . . The

> sentiment that *ex post facto* laws are against natural right, is so strong in the United States, that few, if any, of the State constitutions have failed to proscribe them. . . . [T]hey are equally unjust in civil as in criminal cases, and the omission of a caution which would have been right, does not justify the doing of what is wrong.

T. Jefferson, Letter to Isaac McPherson, Aug. 13, 1813, in 8 *The Writings of Thomas Jefferson* 326-27 (A. Bergh ed. 1903).

Likewise, Chancellor Kent of New York, while acknowledging the holding in *Calder v. Bull*, wrote that "there is no distinction in principle, nor any recognized in practice, between a law punishing a person criminally, for a past innocent act, or punishing him civilly by divesting him of a lawfully acquired right. The distinction consists only in the degree of the oppression, and history teaches us that the government which can deliberately violate the one right soon ceases to regard the other." *Dash v. Van Kleeck*, 7 Johns. 477, 506 (N.Y. Sup. Ct. 1811); *see* 7 Johns. at 503-04 (referring to intentionally retroactive laws as "pernicious" and "repugnant to common justice").

Notwithstanding *Calder v. Bull* and its legal progeny, a number of prominent jurists and scholars in this Century have insisted that the *ex post facto* clauses should apply in the civil context. *See, e.g.*, *Lehmann v. United States ex rel. Carson*, 353 U.S. 685, 690 (Black and Douglas, JJ., concurring in the result), *reh'g denied*, 354 U.S. 944 (1957); *Marcello v. Bonds*, 349 U.S. 302, 319 (Douglas, J., dissenting), *reh'g denied*, 350 U.S. 856 (1955); *see generally* Crosskey, *The True Meaning of the Constitutional Prohibition of Ex-Post-Facto Laws*, 14 Chi. L. Rev. 539 (1947) (citing original historical sources).

In a few cases since *Calder v. Bull*, the Court has even suggested that certain new civil laws, if applied retroactively, could be *per se* unconstitutional. For example, in *Herrick v. Boquillas Land & Cattle Co.*, 200 U.S. 96 (1906), this Court affirmed the Arizona Supreme Court's analysis that "if construed as absolutely barring causes of action existing at the time of its passage [a new statue of limitation] was unconstitutional." 200 U.S. at 102 (agreeing with Arizona Supreme Court -- citing *Sohn v. Watersohn*, 84 U.S. (17 Wall.) 596 (1873)). In 1927 this Court struck down a retroactive application of a federal estate tax as unconstitutional. *Nichols v. Coolidge*, 274 U.S. 531 (1927). Other cases have held that retroactively-imposed tax laws can be "confiscation of property in violation of due process of law." Smead, *The Rule Against Retroactive Legislation: A Basic Principle of Jurisprudence*, 20 Minn. L. Rev. 775, 796 (1936) (reviewing other cases; citations omitted).

Amici believe that retroactive taxation, especially as applied to completed transactions, is inherently unreasonable. More importantly, the *due process and ex post facto* clauses, together with contemporaneous historical indicia, demonstrate that the framers and ratifiers of the United States Constitution shared this belief.

2. *Structural indicia*

a. Retroactive tax laws violate the rule of law underpinnings of the Constitution.

Earlier this Century, the classical liberal scholar Friedrich von Hayek described the Rule of Law, with its inherent restriction on retroactive legislation, as the singlemost distinguishing factor of a free society: "Rule of Law . . . means that the government in all its actions is bound by rules fixed and announced beforehand -- rules which make it possible to foresee with fair certainty how the authority will use its coercive powers in given circumstances and to plan one's individual affairs on the basis of this knowledge." F. von Hayek, *The Road to Serfdom* 72 (1944).

That a general prohibition against retroactive lawmaking is deeply rooted in Anglo/American jurisprudence cannot be disputed. Blackstone argued that "laws should not be enforced before the subjects have an opportunity to become acquainted with them." Smead, *supra*, at 777. James Madison justified restrictions on retroactive laws in the United States Constitution on the grounds that such restrictions "will banish speculations on public measures, inspire a general prudence and industry, and give a regular course to the business of society." *The Federalist* No. 44, at 128-29 (R. Fairfield 2d ed. 1966).

Other contemporaneous legal authorities who influenced the framers and ratifiers of the United States Constitution agreed generally that the type of retroactivity in this case is inherently contrary to the rule of law. For example, Professor Burlamaqui wrote: "It is necessary that the laws be sufficiently notified to the subject; for how could he regulate his actions and motions by those laws, if he had never any knowledge of them?" J. Burlamaqui, *The Principles of Natural Law* 104 (Nugent trans. 3d ed. 1780); *see* J. Burlamaqui, 2 *The Principles of Natural and Politic Law* 154 (Nugent trans. 3d ed. 1784) ("The establishment of civil society ought to be fixed, so as to make a sure and undoubted provision for the happiness and tranquillity of man. For this purpose it was necessary to establish a constant order, and this could only be done by fixed and determinate laws.").

More specifically to the facts of this case, the inherent injustice of a retroactive estate tax law is highlighted by the following example in Baron von Pufendorf's Seventeenth Century treatise *On the Law of Nature and Nations*:

> [A]n accurate distinction should be drawn between the positive law itself, and that right the acquisition of which is occasioned by that law. The former may be annulled afterwards by the legislator, but the right still remains, which was acquired by virtue of that law, so long as it was

> in force. For it would be the height of injustice to abolish along with a law all of its former effects. If, for example, it should be the law of a state, that, *As the head of a house may have disposed of his property by testament, so let the right to it stand*, certainly a legislator will be able to limit this freedom of testament, and to ordain that hereafter all inheritances shall be returned intestate. But it would be unjust to take away all property received by inheritance from those who received legacies while the former law was still in force.

1 Pufendorf, Ch. 6, § 6 (emphasis in original; citations omitted).

Amici respectfully suggest that this and other historical insights into the injustice of retroactive estate taxes are instructive as to how the framers and ratifiers of the United States Constitution would have viewed the type of retroactive federal tax law at issue in this case.

b. As applied to past transactions, retroactive federal laws are judicial in nature, and therefore violate the separation of powers doctrine

In *Calder v. Bull*, Justice Iredell suggested that the Connecticut legislature's exercise of *judicial* power in the form of purely retroactive legislation was "strange," implying that the federal Congress, due to separation of powers principles, could not even countenance the idea:

> It may, indeed, appear strange to some of us, that in any form there should exist a power to grant, with respect to suits depending or adjudged, new rights of trial, new privileges of proceeding, not previously recognized and regulated by positive institutions; but such is the established usage of Connecticut, and it is obviously consistent with the general superintending authority of her

> Legislature. . . . The power, however, is judicial in its nature; and whenever it is exercised, as in the present instance, it is an exercise of judicial, not of legislative, authority.

3 U.S. (3 Dall.) at 398 (Iredell, J., concurring "in the general result," dissenting in part due to "the reasons that are assigned").

Chancellor Kent of New York, author of *Commentaries on American Law* (9th ed. 1858), while acknowledging the holding in *Calder v. Bull* in *Dash v. Van Kleeck*, *supra*, expounded on the judicial nature of retroactive legislation:

> It is equally inadmissible to consider [a legislative] act as declaring how the former statutes were to be *construed*, as to cases already existing. If this interpretation was to be considered as giving the former acts a new meaning, it then becomes a new rule, and is to have the same effect, as any other newly created statute. But if it be considered as an exposition of the former acts for the information and government of the courts in the decision of causes before them, it would then be taking cognisance of a judicial question. This could not *possibly* have been the meaning of the act, for the power that makes is not the power to construe a law. It is a well settled axiom that the union of these two powers is tyranny. . . . Our government . . . consists of departments, and contains a marked separation of the legislative and judicial powers. . . . [T]he right to interpret laws does, and ought to belong exclusively to the courts of justice.

7 Johns. at 508-09 (emphasis in original).

Professor Story later justified the result in *Calder v. Bull* on grounds clearly distinguishable from federal legislation: "There is nothing in the Constitution of the

United States which forbids a State legislature from exercising judicial functions; nor from divesting rights vested by law in an individual, provided its effect be not to impair the obligation of a contract." J. Story, 2 *Commentaries on the Constitution of the United States* 272 (5th ed. 1891).

Justice Scalia more recently opined that retroactivity, while appropriate for judicial decisions, is constitutionally problematic for legislation generally: "[I]t is said that that which distinguishes a judicial from a legislative act is, that the one is a determination of what the existing law is in relation to some existing thing already done or happened, while the other is a predetermination of what the law shall be for the regulation of all future cases." *Harper v. Virginia Dep't of Taxation*, __ U.S. __ , 61 U.S.L.W. 4664, 4669 (June 18, 1993) (Scalia, J., concurring) (quoting T. Cooley, *Constitutional Limitations* 91 (1868)).[10]

To the extent the 1987 amendment to the Tax Reform Act of 1986 is what the Committee Report purports, *i.e.*, a conforming amendment to bring the Tax Reform Act of 1986 in line with "the original intent of Congress." H.R.Rep. No. 100-391, 100th Cong., 1st Sess., Pt. II, at 1045 (1987), the 1987 amendment, as applied to this case, is judicial in nature and therefore contrary to the separation of powers doctrine.

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[10] *See* Aiken, *Ex Post Facto in the Civil Context: Unbridled Punishment*, 81 Ky. L.J. 323, 327-33 (1993) (discussing historical bases for *ex post facto* restrictions vis-à-vis separation of powers); *see generally* Laycock, *Due Process and Separation of Powers: The Effort to Make the Due Process Clauses Nonjusticiable*, 60 Tex. L. Rev. 875, 878 (1982) ("the due process clauses look to legislatures only for substantive entitlements, and . . . the clauses commit minimum procedural rights to the Constitution and therefore to the Court"), *citing* Michelman, *Formal and Associational Aims in Procedural Due Process*, in Nomos XVIII: Due Process 126, 133-34, 158-59 n.27 (J.R. Pennock and J. Chapman eds. 1977).

c. Federal legislative power does not extend between Congresses

Article 1, Section 1 vests all "legislative powers . . . in a Congress of the United States, which shall consist of a Senate and a House of Representatives." Every two years a new Congress is formed, and this Court has observed that the views of one Congress about the intent of a prior enacting Congress are entitled to little deference. *See United States v. Vogel Fertilizer Co.*, 455 U.S. 16, 34 (1982); *International Bhd. of Teamsters v. United States*, 431 U.S. 324, 354 n. 39 (1977); *see also United Airlines v. McMann*, 434 U.S. 192, 200 n.7 (1977) ("Legislative observations 10 years after the passage of the Act are in no sense part of the legislative history.").

In September of 1986 the 99th Congress enacted an estate tax deduction for sales of employer securities to ESOP's within the Tax Reform Act of 1986, after which it adjourned. More than a year later, the newly elected and substantially transformed 100th Congress enacted another law, labeled a "Congressional Clarification of Estate Tax Deduction for Sales of Employer Securities," which purported to conform the Tax Reform Act of 1986 to "the original intent of Congress." H.R.Rep. No. 100-391, 100th Cong., 1st Sess., Pt. II, at 1045 (quoted at *Carlton*, 972 F.2d at 1054-55). But one Congress cannot definitely speak for the intent of another, for such would be an usurpation of judicial power. *Cf. James B. Beam Distilling Co. v. Georgia*, ___ U.S. ___, ___, 111 S. Ct. 2439, 2450-51 (Scalia, J., joined by Marshall and Blackmun, JJ.) (discussing judicial retroactivity vis-à-vis the division of federal powers).

The limitation in Article 1, Section 1 of "all legislative power" to "a Congress" suggests that the legislative power does not extend between Congresses. Accordingly, once a Congress has adjourned, that Congress' intent cannot be reconsidered by a subsequent Congress, especially as to cases and controversies wherein individuals have relied upon a law enacted by the prior Congress. As Chief

Justice Marshall admonished in *Fletcher v. Peck*, 10 U.S. (6 Cranch) 87 (1810), "if an act be done under a law, a succeeding legislature cannot undo it. The past cannot be recalled by the most absolute power." 10 U.S. (6 Cranch) at 135 (discussing contract clause restrictions on state governments).

Because Carlton's transaction was completed under section 2057, as enacted by the 99th Congress, the 1987 amendment by the 100th Congress "cannot undo it." *Id.*

d. The federal *ex post facto* clause should be construed broadly for a government of limited powers

To the extent a power to enact retroactive legislation turns on presumptions (such as the presumption that the founders intended the term "*ex post facto*" to apply only to criminal statutes), any such presumptions should take into consideration the fundamentally different natures of state versus federal governmental powers in the United States.[11] As the Court clarified in *Butler*:

> Each state has all governmental powers save such as the people, by their Constitution, have conferred upon the United States, denied to the

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[11] *See* T. Cooley, *Constitutional Limitations* 173 (1868) ("The government of the United States is one of *enumerated* powers; the governments of the States are possessed of all the general powers of legislation. When a law of Congress is assailed as void, we look in the national Constitution to see if the grant of specified powers is broad enough to embrace it; but when a State law is attacked on the same ground, it is presumably valid in any case, and this presumption is a conclusive one, unless in the Constitution of the United States or of the State we are able to discover that it is prohibited. . . . Congress can pass no laws but such as the Constitution authorizes either expressly or by clear implication; while the State legislature has jurisdiction of all subjects on which its legislation is not prohibited."). Accordingly, a state government may be presumed to have a power to enact retroactive civil laws while the federal government is presumed not to have such power.

> states, or reserved to themselves. The federal union is a government of delegated powers. It has only such as are expressly conferred upon it and such as are reasonably to be implied from those granted. In this respect we differ radically from nations where all legislative power, without restriction or limitation, is vested in a parliament or other legislative body subject to no restrictions except the discretion of its members.

297 U.S. at 63.

The power of Congress to tax *retroactively* is neither enumerated nor "reasonably to be implied from those granted." 297 U.S. at 63. As the Court concluded in *Butler*, "the only thing granted [in art. I, § 8, cl. 1] is the power to tax for the purpose of providing funds for payment of the nation's debts and making provision for the general welfare." 297 U.S. at 64; *see* 297 U.S. at 69-70 ("It would undoubtedly be an abuse of the [taxing] power . . . if exercised for ends inconsistent with the limited grants of power in the Constitution."), *quoting Veazie Bank v. Fenno*, 8 Wall. 533, 541 (1868). The Solicitor General would extend this limited power to include the power retroactively to amend "revenue laws to fairly allocate to taxpayers the burdens and benefits of national fiscal policies and to prevent evasion of those laws 'by the vigilant and ingenious.'" United States Brief at 15. Such an extension of non-enumerated power to Congress, to use the Solicitor General's own words (United States Brief at 19), "lacks a foundation" in either the text or the structure of the United States Constitution.

CONCLUSION

Amici urge the Court to affirm the Ninth Circuit's due process holding, and in so doing to provide a "bright line" constitutional test for retroactive federal tax legislation based on the constitutional guarantee of procedural due process, as well as on the other textual and structural indicia of intent by the framers and ratifiers of the

Constitution to protect individuals from a federal law that would tax, or increase net taxes on, past activities. The Constitution prohibits retroactive application of federal tax laws as to completed transactions and prohibits retroactive application generally unless necessary to achieve a compelling legislative purpose independent of the desire to raise additional revenues.

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